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Supreme Court of the United States

OCTOBER TERM, 1952

No. 76 + 138

EDWIN E. HEALY AND GORDON W. HARTFIELD,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED MAY 20, 1952
CERTIORARI GRANTED OCTOBER 13, 1952

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1952

No. 76

EDWIN E. HEALY AND GORDON W. HARTFIELD,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., OCT. 27, 1952.

At all times pertinent hereto, Hartfield was vice-president and treasurer and Healy was president of Hartfield-Healy Supply Company, Inc., a New York corporation (hereinafter called the corporation), and each petitioner owned 25 of the total of 52 shares of the corporation's common stock.

Each petitioner included in his individual income tax return for 1945 the \$30,000 received as salary. During the year 1945, the corporation paid insurance premiums on the lives of Hartfield and Healy in the amounts of \$1,044.20 and \$1,131.25, respectively, which premiums were for petitioners' benefit.

Respondent upon examination of the corporation's return for 1945 determined that \$10,000 of the salary paid to each petitioner and the life insurance premiums paid for petitioners were excessive compensation and disallowed such payments as deductions. Similar determinations were made to the corporation's income by respondent for salaries paid in the years 1941, 1942, and 1943, which amounts are set out below:

Year	Amounts paid	Amounts disallowed
1941	\$28,000	\$8,000
1942	62,000	22,000
1943	62,000	2,000

In addition, the Commissioner disallowed as excessive compensation in 1943, the payment of life insurance premiums by the corporation for the benefit of the petitioners in the total amount of \$2,175.45. The following deficiencies in tax and interest resulted from those disallowances:

Year	Income tax	Excess profits tax	Interest
1941	\$1,523.64	\$1,882.37	\$476.14
1942	420.02	20,360.01	3,100.06
1943	221.07		11.63

The 1945 income tax of the corporation showed a net loss of \$45,232.75. Because of the disallowance of excessive compensation and several other minor adjustments, the corporation's net loss for 1945 was reduced to \$21,741.29. The application of the net loss carry-back based upon that

[fol. 11] adjusted net loss resulted in the elimination of the 1942 and 1943 income tax deficiencies and the interest thereon and reduced the 1942 excess profits tax deficiency by the amount of \$13,834.70 and the interest due thereon by the amount of \$1,489.80. There remained unpaid by the corporation the following deficiencies in tax and interest:

Year	Income tax	Excess profits tax	Interest
1941	\$1,523.64	\$1,882.37	
1942		6,525.31	\$1,465.33

On December 31, 1947, each petitioner advanced \$5,250 to the corporation to be used to pay the remaining income and excess profits tax deficiencies and interest, and on that same day, the corporation paid \$9,931.32 out of those funds to the collector of internal revenue at Buffalo, New York, in partial satisfaction of those deficiencies.

On December 24, 1948, each petitioner paid \$715.37 to the collector of internal revenue at Buffalo in satisfaction of the balance due from the corporation on the said deficiencies. The petitioners made no further payments on any deficiencies.

The corporation paid no dividends during 1945.

OPINION

BLACK, Judge:

The sole question herein is whether that portion (or any part thereof) of petitioners' salaries which was disallowed as a deduction in the taxable year to a corporation as being excessive is includible in petitioners' income where the corporation was insolvent and petitioners as transferees satisfied, in a subsequent year, the tax deficiencies of the corporation pertaining to years other than the taxable year, which arose as a result of the disallowance of excessive salaries in those other years. No question is raised by either party as to the insolvency of the corporation or as to the liability of petitioners as transferees.

Petitioners contend that the excessive salaries which they received from the corporation in 1945 are not includible in their incomes because the disallowance of these salaries (in [fol. 12] addition to several other minor adjustments) reduced the corporation's net loss for 1945, and in the appli-

cation of the net loss carry-back there remained tax deficiencies of the corporation for the years 1941 and 1942 which petitioners voluntarily satisfied as transferees.

Respondent contends that the full amount of the salaries received in 1945 is includible in petitioners' incomes and may not be reduced by the amount of excessive salary determination, and in any event the most that petitioners would be entitled to as an exclusion would be the amount subsequently paid as transferees.

The facts herein are almost identical with those in *Hall C. Smith*, 11 T. C. 174, and we believe that case governs the instant proceedings. In the *Smith* case the transferee liability had already been determined by this Court in a prior proceeding and petitioner was found liable as a transferee to the full extent of the excessive compensation received by him in 1943. Although the transferee liability was not determined until 1948 (*Hall C. Smith, Transferee*, Docket No. 9462, aff'd., 184 Fed. (2d) 1011), we held that the petitioner therein had not received taxable income in 1943. We said:

* * * Here, there was a definite legal restriction of the petitioner's use of the excessive compensation which attached the moment that he received it. Such is the nature of a transferee liability.

There is obvious inconsistency, as well as injustice, in the respondent's position in seeking to tax the petitioner on income to which he, the respondent, has successfully laid claim on the ground that it was never the petitioner's income by right.

The fact that the transferee liability was admitted by the petitioners in the instant proceedings should not place them in a worse position than was the petitioner in *Hall C. Smith, supra*, and we cannot therefore distinguish the cases on this fact. In *Hall C. Smith, supra*, the transferee liability exceeded the amount of excessive compensation and we therefore held that all of the excessive compensation was impressed with a trust and was not taxable income to petitioner when received. Petitioners herein claim that the full amount of their excessive compensation is likewise not taxable income.

Although respondent disagrees with the result in *Hall C.*

Smith, supra, he argues that even if we are to follow the rationale of the *Smith* case, that case does not support petitioners' contention that *all* of *their* excessive compensation received in 1945 is not taxable income. Respondent contends that only the amounts actually used to satisfy the corporate deficiencies (\$5,681.03 from each petitioner) should be excluded from taxable income. We agree with the contention because the only amounts which petitioners received as excessive compensation in the taxable year, which were not income, were the amounts ultimately paid in satisfaction of their transferee liabilities which amounts were impressed with a trust from the time of their receipt. *Hall C. Smith, supra; Commissioner v. Turney*, 82 Fed. (2d) 661.

Decisions will be entered under Rule 50.

IN THE TAX COURT OF THE UNITED STATES

Docket No. 22944

GORDON W. HARTFIELD, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION—Entered March 14, 1951

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion promulgated January 26, 1951, the respondent herein filed a computation on March 13, 1951, to which petitioner acquiesced, now therefore, it is

Ordered and Decided: that there is an overpayment in income tax for the calendar year 1945 in the amount of \$3,049.68, which amount was paid within three years before the execution of an agreement pursuant to section 276(b) [fol. 14] which was executed within three years from the time the return was filed by the taxpayer.

(Signed). Eugene Black, Judge.

Recorded Docket M.S. 8.

[fol. 1]

**APPENDIX TO BRIEF FOR APPELLANT IN THE
TAX COURT OF THE UNITED STATES**

GORDON W. HARTFIELD, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

For Petitioner: James H. Heffern, Esq.

For Respondent: Michael Waris, Esq.

DOCKET ENTRIES

Appearances:

1949

May 9. Petition received and filed. Taxpayer notified.

May 9. Request for Circuit hearing in Buffalo, New York
filed by taxpayer. Granted 5/12/49.

May 10. Copy of petition served on General Counsel.

July 8. Answer filed by respondent.

July 12. Copy of answer served on taxpayer, Buffalo,
New York.

Aug. 30. Hearing set Oct. 31, 1949, Buffalo, New York.

Oct. 31. Hearing had before Judge Black on the merits.
Stipulation of facts and exhibits filed. Briefs, December 15,

1949. Replies Jan. 5, 1950.

Nov. 7. Transcript of Hearing 10/31/49 filed.

Dec. 9. Brief filed by taxpayer. Copy served 12/16/49.

Dec. 15. Brief filed by General Counsel.

1950

Jan. 11. Reply brief filed by taxpayer. Copy served.

1951

Jan. 26. Findings of fact and opinion rendered. Black J.
Decision will be entered under Rule 50. Copy served.

Mar. 13. Agreed computation for entry of decision filed.

[fol. 2] Mar. 14. Decision entered. Black J. Div. 15.

June 13. Petition for review by U. S. Court of Appeals
for the Second Circuit filed by General Counsel.

June 13. Notice of filing petition for review sent to James H. Heffern, counsel for taxpayer.

July 10. Proof of service of petition for review from Gordon W. Hartfield, taxpayer.

July 13. Motion for extension to Sept. 11, 1951 to complete and transmit the record on review filed by General Counsel.

July 13. Order enlarging time to Sept. 11, 1951 to prepare and transmit the record entered.

Aug. 21. Statement of Points filed by taxpayer with service thereon.

Aug. 21. Designation of contents of record filed by taxpayer with service thereon.

Aug. 29. Certified copy of an order from the Second Circuit consolidating cases for briefs, hearing, and decision upon a single consolidated transcript of record filed.

IN THE TAX COURT OF THE UNITED STATES

EDWIN E. HEALY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

For Petitioner: James H. Heffern, Esq.

For Respondent: Michael Waris, Esq.

DOCKET ENTRIES

Appearances:

1949

May 9. Petition received and filed. Taxpayer notified. Fee paid.

May 9. Request for Circuit hearing in Buffalo, N. Y. filed by taxpayer. Granted 5/12/49.

May 10. Copy of petition served on General Counsel.

July 8. Answer filed by Respondent.

July 12. Copy of answer served on taxpayer, Buffalo, New York.

[fol. 3] Aug. 30. Hearing set Oct. 31, 1949, Buffalo, New York.

Oct. 31. Hearing had before Judge Black on the merits. Stipulation of facts and exhibits filed. Briefs, December 15, 1949. Replies Jan. 5, 1950.

Nov. 17. Transcript of Hearing 10/31/49 filed.

Dec. 9. Brief filed by taxpayer. Copy served 12/16/49.

Dec. 15. Brief filed by General Counsel.

1950

Jan. 11. Reply brief filed by taxpayer. Copy served.

1951

Jan. 26. Findings of fact and opinion rendered. Black J. Decision will be entered under Rule 50. Copy served.

Mar. 13. Agreed computation for entry of decision filed.

Mar. 14. Decision entered, Black J. Div. 15.

June 13. Petition for review by United States Court of Appeals for the Second Circuit filed by General Counsel.

June 13. Notice of filing petition for review sent to James H. Heffern, counsel for taxpayer.

July 10. Proof of service of petition for review from Edwin E. Healy, taxpayer.

July 13. Motion for extension to Sept. 11, 1951, to complete and transmit the record on review filed by General Counsel.

July 13. Order enlarging time to Sept. 11, 1951 to prepare and transmit the record entered.

Aug. 21. Statement of Points filed by taxpayer with service thereon.

Aug. 21. Designation of contents of record filed by taxpayer with service thereon.

Aug. 29. Certified copy of an order from the Second Circuit consolidating cases for briefs, hearing, and decision upon a single consolidated transcript of record filed.

[fol. 4] IN THE TAX COURT OF THE UNITED STATES

STIPULATION OF FACTS—Filed October 31, 1949

It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either

party to introduce other and further evidence not inconsistent with the facts herein stipulated to be true. It is also stipulated that these proceedings may be consolidated for hearing and opinion.

1. Gordon W. Hartfield and Edwin E. Healy, both on a cash receipts and disbursements basis, filed their 1945 Federal income tax returns and paid the tax shown to be due thereon on or about the 27th day of March, 1946, with the Collector of Internal Revenue for the Twenty-Eighth District of New York. Copies of said returns are attached hereto marked Exhibits 1 and 2, respectively, and made a part hereof.

2. At all times pertinent hereto, Hartfield was vice-president and treasurer and Healy was president of Hartfield-Healy Supply Company, Inc., a New York corporation (hereafter called the corporation), and each petitioner owned 25 of the total of 52 shares of the corporation's common stock.

3. The corporation paid to the petitioners as salaries, and the Commissioner disallowed as excessive the following amounts:

	Amounts paid	Amounts disallowed
1941		
1942	\$28,000.00	\$ 8,000.00
1943	62,000.00	22,000.00
	62,000.00	2,000.00

In addition, the Commissioner disallowed as excessive compensation, in 1943, the payment of life insurance premiums by the corporation for the benefit of the petitioners in the total amount of \$2,175.45. The following [fol. 5] deficiencies in tax and interest resulted from those disallowances:

	Income tax	Excess profits tax	Interest
1941	\$1,523.64	\$ 1,882.37	\$ 476.14
1942	420.02	20,360.01	3,100.06
1943	221.07		11.63

4. During the year 1945, the corporation made cash salary payments to Healy in the amount of \$1,193.80 and to Hartfield in the amount of \$1,212.10, in each of the first three months of that year and in the amount of \$500.00 in each of

the nine remaining months, or a total of \$8,081.40 to Healy and \$8,136.30 to Hartfield. In December, it accrued \$21,918.60 as additional 1945 salary payable to Healy and \$21,863.70 to Hartfield, and charged against each of those accounts the amount of \$5,042.70 which represented the amount of withholding tax paid by it in connection with each salary. On March 30, 1946, cash payments representing the balance of the 1945 accrued salaries were made to Healy and Hartfield in the respective amounts of \$16,875.90 and \$16,821.00.

5. The 1945 Federal income tax return of the corporation, a copy of which is attached hereto and marked Exhibit 3, showed a net loss for that year of \$45,232.75. Upon examination of that return, the Commissioner determined that \$10,000 of the salary paid and accrued by the corporation in 1945 to each of the petitioners was excessive compensation, and that life insurance premiums paid by the corporation in 1945 for the benefit of Hartfield in the amount of \$1,044.20, and for the benefit of Healy in the amount of \$1,131.25 also were excessive compensation, and disallowed those excessive payments as deductions from the corporation's income for 1945. Because of those disallowances and several other minor adjustments, the corporation's net loss for 1945 was reduced to \$21,741.29. The application of the net operating loss carry-back based upon that adjusted net loss resulted in the elimination of the 1942 and 1943 income tax deficiencies and the interest thereon and reduced the 1942 excess profits tax deficiency by the amount of \$13,834.70 and the interest due thereon by the amount of \$1,589.80. There [fol. 6] remained unpaid by the corporation the following deficiencies in tax and interest:

	Income tax	Excess profits tax	Interest
1941	\$1,523.64	\$1,882.37	
1942		6,525.31	\$1,465.32

6. On December 31, 1947, each petitioner advanced \$5,250.00 to the corporation to be used to pay the said remaining income and excess profits tax deficiencies and interest, and on that same day, the corporation paid \$9,931.32 out of those funds to the Collector of Internal Revenue at Buffalo, New York, in partial satisfaction of those deficiencies.

6.

7. There is attached hereto and marked Exhibit 4 a copy of a letter dated December 3, 1947, addressed to the Revenue Agent in Charge in Buffalo relating to the payment of said remaining deficiencies.

8. On December 24, 1948, each petitioner paid \$717.37 to the Collector of Internal Revenue at Buffalo in satisfaction of the balance due from the corporation on the said deficiencies. The petitioners made no further payments on any deficiencies.

9. The corporation paid no dividends during 1945.

10. The balance sheets of the corporation as of December 31, 1944, and 1945, were as follows:

Assets		
	Dec. 31, 1944	Dec. 31, 1945
Cash	\$13,720.74	\$10,970.37
Notes and Accounts Receivable	29,776.32	18,878.50
Inventories	29,201.20	37,682.03
U. S. Government bonds	18.75	
Deposits Restricted	435.00	
Post War Refund bonds		4,410.24
Reserve against bonds		(1,516.50)
Depreciable Assets	1,723.20	1,723.20
Reserve for Depreciation	(675.11)	(847.43)
Prepaid Insurance	97.86	
Due from Officers	3,989.12	686.79
Organization Expense	214.17	214.17
Post War Refund	6,674.57	1,941.57
Reserved for Post War Refund	(2,264.33)	(1,941.57)
	<hr/> \$82,911.49	<hr/> \$72,201.46
Liabilities		
Accounts Payable	\$18,408.76	\$11,837.83
Notes Payable	28,491.10	66,696.90
Accrued Expenses	3,998.00	12,286.58
Accrued Federal Income Tax	25,760.07	7,888.35
Due U.S. Account Renegotiation	4,934.80	
Capital Stock	5,200.00	5,200.00
Deficit	(3,881.24)	(31,708.20)
	<hr/> \$82,911.49	<hr/> \$72,201.46

[fol. 7] 11. It is hereby stipulated and agreed that the Commissioner correctly included life insurance premiums paid by the corporation in the taxable income of Hartfield and Healy as additional compensation for the calendar year 1945 in the respective amounts of \$1,044.20 and \$1,131.25.

(Sgd.) James H. Heffern, (Counsel for Petitioners).

(Signed) Charles Oliphant, RPH, Chief Counsel,
Bureau of Internal Revenue.

EXHIBIT 4

Albrecht, Maguire & Mills
1300 Genesee Building
Buffalo 2, New York

December 3, 1947.

(TR 60-61)

Revenue Agent in Charge
Jackson Building
Buffalo, New York

In re: Hartfield-Healy Supply Company, Inc.

1941-1942

1943-1945

DEAR SIR:

Pursuant to recent conferences with your office in the above entitled matters, we are submitting the following proposal as a basis for settlement of the pending matters which affect the income tax and excess profits tax liability of Hartfield-Healy Supply Company, Inc.:

1. The findings set out in the Revenue Agent's Report of January 23, 1947, to be revised by the allowance of an additional \$10,000.00 as officers' salaries, the effect of this being to increase by that amount the loss for the year 1945 from \$11,741.29 to \$21,741.29.

2. The 1945 loss as so revised to be carried back to the year 1943, and a recalculation to be made of the over-assessment for that year.

[fol. 8] 3. The overassessment so determined to be applied

against the outstanding deficiencies heretofore determined for the years 1941 and 1942.

4. All of this to be with the understanding that the net deficiencies for the years 1941 and 1942 are to be paid subject only to such arrangements as to terms, if any, as can be arranged between the taxpayer and the Collector; and with the further understanding that no further reduction in such net deficiencies will be sought by the taxpayer.

5. All of this to be with the further understanding that this proposal and the undertaking for payment are to be participated in by Edwin E. Healy and Gordon W. Hartfield in addition to the taxpayer itself.

6. Such formal papers by way of acceptance or consent forms as may be necessary to be executed by the taxpayer.

We are authorized to submit the foregoing proposal on behalf of Hartfield-Healy Supply Company, Inc., Edwin E. Healy and Gordon W. Hartfield, all of whom signify their approval thereof and their assurance of compliance therewith by adding their signatures at the end of this letter.

Respectfully, Albrecht, Maguire & Mills, Frank J. Maguire.

We, the undersigned, hereby approve and authorize the foregoing proposal for settlement of pending matters involving the income taxes and excess profits taxes of Hartfield-Healy Supply Company, Inc., and agree that if said proposal is accepted, we will jointly see to the carrying out of the terms thereof.

Hartfield-Healy Supply Company, Inc., by _____,
President; Edwin E. Healy, Gordon W. Hartfield.

December 3, 1947.

FJM:jw.

[fol. 9] IN THE TAX COURT OF THE UNITED STATES

FINDINGS OF FACT AND OPINION OF THE TAX COURT

These consolidated proceedings involve deficiencies and claims for overpayment of income tax for 1945, as follows:

Petitioner	Docket No.	Deficiency	Claim for overpayment
Gordon W. Hartfield	22944	\$567.51	\$6,202.09
Edwin E. Healy	22945	1,029.89	4,437.71

The major portion of the deficiencies results from respondent's determination that additional compensation was received for the year 1945 in the amounts of \$1,044.20 by petitioner Gordon W. Hartfield and \$1,131.25 by petitioner Edwin E. Healy. This adjustment was explained in a statement attached to the deficiency notice in Docket No. 22944, as follows:

(a) Life insurance premiums paid in your behalf by the Hartfield-Healy Supply Company are held to constitute taxable income to you.

A similar explanation was given in Docket No. 22945.

Petitioners have stipulated that respondent properly included these amounts as additional compensation; however, by appropriate assignments of error petitioners contest respondent's determination that all the amounts of compensation received by petitioners in 1945 which respondent determined as excessive, and thereby disallowed the deduction of same by Hartfield-Healy Supply Company, represent taxable income to petitioners.

FINDINGS OF FACT

The facts, all of which have been stipulated, are found as stipulated and may be summarized, as follows:

Petitioner Gordon W. Hartfield (hereinafter called Hartfield) and petitioner Edwin E. Healy (hereinafter called Healy), both on a cash receipts and disbursements basis, filed their 1945 income tax returns and paid the tax shown to be due thereon on or about March 27, 1946, with the [fol. 10] collector of internal revenue for the 28th district of New York.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1952

No. 138

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

HALL C. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SIXTH CIRCUIT

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IN THE TAX COURT OF THE UNITED STATES

Docket No. 22945

EDWIN E. HEALY, Petitioner,

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION—Entered March 14, 1951

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion promulgated January 26, 1951, the respondent herein filed a computation on March 13, 1951, to which petitioner acquiesced, now therefore it is

Ordered and Decided: that there is an overpayment in income tax for the calendar year 1945 in the amount of \$2,619.93, which amount was paid within three years before the execution of an agreement pursuant to section 276(b) which was executed within three years from the time the return was filed by the taxpayer.

(Signed) Eugene Black, Judge.

Recorded Docket M.S. 8.

[fol. 15] UNITED STATES COURT OF APPEALS FOR THE SECOND
CIRCUIT, OCTOBER TERM, 1951

Nos. 153-154

(Argued January 17, 1952. Decided February 15, 1952)

Docket Nos. 22127-22128

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

GORDON W. HARTFELD, Respondent

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

EDWIN E. HEALY, Respondent

Before Augustus N. Hand and Clark Circuit Judges, and
Brennan, District Judge

Petition to review the determination of the Tax Court
finding that there were overpayments in the petitioners'
income tax for the calendar year 1945:

[fol. 16] Theron Lamar Caudle, Assistant Attorney Gen-
eral, Ellis N. Slack, A. F. Prescott, Graham Loving, Jr.,
Special Assistants to the Attorney General.
James H. Heffern, Attorney for Respondents.

BRENNAN, District Judge:

This appeal questions the taxable status of the alleged
overpayment by the taxpayers of income tax for the calen-
dar year 1945. The facts are not complicated; the issue
of law is concise.

At the times pertinent here, George W. Hartfield and
Edwin E. Healy were officers of the Hartfield-Healy Sup-
ply Company, Inc., a New York corporation, and each was
the owner of twenty-five of the fifty-two outstanding shares
of stock. In 1945 the corporation was insolvent. During
that year there was paid by the corporation as salary to
each of the above named officers the sum of \$30,000. Such

1 payments were reported on the corporate tax return for that year, and were reported as income received by the recipients in their 1945 individual income tax returns, which were made on a cash basis.

Upon later examination of the corporate return, the Commissioner found that \$10,000 of the amount paid to each taxpayer as salary, and about \$1000 in life insurance premiums paid for him were excessive, and same were disallowed as deductions therein. Other determinations affecting the corporate returns in prior years were made, resulting in tax deficiencies. In 1947 and 1948 Hartfield and Healy each paid to the Collector direct, or through the corporation, a total of about \$7,000 to satisfy the balance of the deficiencies due from the corporation. The determinations of the Commissioner above referred to, the [fol. 17] insolvency of the corporation, and the liability of respondents as transferees in the amounts paid are not disputed.

Appropriate proceedings were instituted by Hartfield and Healy to recover the claimed overpayment of their individual 1945 income tax based upon the facts as outlined above. The proceedings were consolidated, and the Tax Court held (16 T. C. 200), that the amounts actually paid to satisfy the corporate tax deficiencies were impressed with a trust from the time of their receipt as salaries, and should be excluded from the taxable income of respondents as shown in their returns. It was held that they should accordingly recover the resulting overpayments.

A legal issue arises by reason of the petitioner's contention that the lower court was in error in concluding that respondents' returns for 1945 should be reopened to reflect subsequent facts.

Since the decision below, the Supreme Court in *U. S. v. Lewis*, 340 U. S. 590, has re-affirmed the "claim of right" doctrine, as enunciated in *North American Oil v. Burnet*, 286 U. S. 417, and refers to same as "... now deeply rooted in the federal tax system." This court in the case of *Commissioner v. Bauer*, decided January 10, 1952, cited *U. S. v. Lewis*, and recognized that a tax return for a previous year may not be reopened to reflect subsequent facts as a well-settled principle.

There would seem to be no question here that the re-

spondents received their 1945 salaries from the corporation under a claim of right, and without restriction as to their disposition, which is the test outlined in the *North American Oil* case. The fact that such salaries were reported on the individual tax returns as earnings or income would seem to be determinative of that question.

There remains then only respondents' contention that such salaries were received impressed with a trust by reason of the provisions of the Internal Revenue Code relative to the liability of transferees, or the provisions of Section 15 of the Stock Corporation Law of the State of New York. The latter contention was not raised below.

The liability of the taxpayers as transferees must necessarily have awaited the determination as to the existence and amount of the excessive salary payments. It was not fixed in 1945. Even though corporate insolvency were admitted, the liability of the officers did not exist until excessive payments were determined as a fact, and it was established that a deficiency in the corporate tax existed. The citation of *North American Oil v. Burnet, supra*, and *U. S. v. Lewis, supra*, would seem to be sufficient to demonstrate that the decision below cannot stand upon the transferee trust fund theory. (See also *Fleischer v. Commissioner*, 158 F. 2d 42.) This seems to be recognized by the Tax Court itself in *Pittman v. Commissioner*, 14 T. C. 449.

Section 15 of the Stock Corporation Law of the State of New York is not applicable here. If it has any bearing on a question of federal taxation, we are not persuaded that it would override the legal principle above referred to. In any event it would apply only in case of payments made with the intent of giving a preference to creditors. Such intent must exist or be established to invoke the statute and to establish a liability upon the recipient. The contention lacks a factual basis. (*N. Y. Credit Men's Association v. Hasenberg*, 26 F. Supp. 877; affirmed 107 F. 2d 1020, *per curiam*.)

Reversed.

[fols. 18-20] UNITED STATES COURT OF APPEALS, SECOND
CIRCUIT

At a Stated Term of the United States Court of Appeals in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 15th day of February, one thousand nine hundred and fifty-two.

Present: Hon. Augustus N. Hand, Hon. Charles E. Clark
Circuit Judges; Hon. Stephen W. Brennan, District Judge

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

GORDON W. HARTFELD, Respondent

JUDGMENT

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

Alexander M. Bell, Clerk.

[fols. 21-22] UNITED STATES COURT OF APPEALS, SECOND
CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 15th day of February, one thousand nine hundred and fifty-two.

Present: Hon. Augustus N. Hand, Hon. Charles E. Clark, Circuit Judges; Hon. Stephen W. Brennan, District Judge.

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

EDWIN E. HEALY, Respondent

JUDGMENT

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Alexander M. Bell, Clerk.

[fol. 23] Clerk's Certificate to foregoing paper omitted in printing.

[fol. 24] SUPREME COURT OF THE UNITED STATES, OCTOBER
TERM, 1951

No. —

EDWIN E. HEALY, Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE

GORDON W. HARTFIELD, Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE

ORDER

Upon consideration of the application of counsel for the petitioners,

It is ordered that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including May 29, 1952.

Robert H. Jackson, Associate Justice of the Supreme Court of the United States.

Dated this 12th day of May, 1952.

[fol. 21] SUPREME COURT OF THE UNITED STATES, OCTOBER
TERM, 1952

No. 76

[Title omitted]

ORDER ALLOWING CERTIORARI—Filed October 13, 1952

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted. The case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(4550)

LIBRARY
SUPREME COURT, U.S.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1952

No. 138

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

HALL C. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 18, 1952.
CERTIORARI GRANTED OCTOBER 13, 1952

14 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

tion of the deficiency herein respondent erred in the manner and form as alleged in paragraph 4 of the petition.

5 (a) and (b). Denies the allegations contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

(c) Admits the allegations contained in subparagraph (c) of paragraph 5 of the petition.

(d) Admits the allegations contained in subparagraph (d) of paragraph 5 of the petition, but denies that said salaries were reasonable.

(e) Admits that petitioner acquired all the capital stock of the Charles E. Smith and Sons Company in the amount of \$30,000 in 1951; that on October 15, 1942, petitioner acquired all of an additional issue of stock of said company in the amount of \$30,000; and that said petitioner held said stock in the amount of \$60,000 until January 7, 1943, when he sold \$30,000 of it to said company. Denies the remaining allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f) Admits that the Commissioner of Internal Revenue in reviewing the income tax returns of the Charles E. Smith and Sons Company for the taxable years 1942 and 1943 determined that a reasonable allowance for salary (paid petitioner) to be deducted by said company was \$25,000 for 1942 and \$30,000 for 1943; that the amount of \$57,265.08 of a total of \$87,265.08 salary paid by said company to petitioner together with the \$30,000 paid by the company to petitioner in redemption of its stock (par. 5 (e) *supra*) rendered said company insolvent and therefore rendered petitioner liable as transferee to the extent thereof for the deficiencies in tax and penalty determined by the Commissioner to be due and owing from said company for the taxable years 1942 and 1943; and that said determinations were sustained by this Court. Denies the remaining allegations contained in subparagraph (f) of paragraph 5 of the petition.

(g) Admits that petitioner reported as income the salaries received from The Charles E. Smith and Sons Company in the amounts of \$52,000.00 for 1942 and \$87,265.08 for 1943. Denies the remaining allegations contained in subparagraph (g) of paragraph 5 of the petition.

(h) Denies the allegations contained in subparagraph (h) of paragraph 5 of the petition.

(i) Admits that in the year 1941 petitioner paid \$30,000 for 300 shares of the stock of said Charles E. Smith and Sons Company and in the year 1942 paid \$30,000 for an additional 300 shares of stock in said Charles E. Smith and Sons Company; that on January 7, 1943, petitioner returned the 300 shares of said stock to said corporation in exchange for \$30,000. Denies the re-

maintaining allegations contained in subparagraph (i) of paragraph 5 of the petition.

21 (j) Denies the allegations contained in subparagraph (j) of paragraph 5 of the petition.

6. Answering the amendment to the petition respondent admits that same is a true copy of a claim filed by petitioner with the Collector of Internal Revenue for the 1st District of Ohio.

7. Denies generally each and every allegation contained in the petition and the amendment to petition not hereinabove specifically admitted, qualified, or denied.

WHEREFORE, it is prayed that the petition be denied and that respondent's determination be in all respects approved.

CHARLES OLIPHANT (wwk),
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

DEWITT M. EVANS,
Division Counsel.

JOHN O. DURKAN,
Special Attorney,
Bureau of Internal Revenue.

22 Exhibit 1 to answer do petition

COPY

September 4, 1947
Filing District
First Ohio

CinD: SN: DAR mec

Mr. Hall C. Smith,

R. R. No. 4, Batavia, Ohio

DEAR MR. SMITH: You are advised that the determination of your income tax liability for the taxable year ended December 31, 1943, discloses a deficiency of \$422.20, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Cincinnati, Ohio, for the attention of CinD:

1 In The Tax Court of the United States

Docket No. 15836

HALL C. SMITH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances

For Petitioner: Sol Goodman, Esq. For Respondent: J. O. Durkan, Esq.; R. C. Whitley, Esq.

Docket Entries

1947

Sept. 15—Petition received and filed. Taxpayer notified. Fee paid.

Sept. 16—Copy of petition served on General Counsel.

Sept. 17—Motion to consolidate with dockets 9461, 9462 and 184-R filed by taxpayer.

Sept. 19—Notice of Hearing 10-8-47 on petitioner's motion—Washington, D. C.

Sept. 22—Amendment to petition filed by taxpayer. 9-23-47 copy served.

Oct. 8—Hearing had before Judge Turner on motion of petitioner to consolidate or to stay proceeding in dockets 9461 and 9462 to strike 184-R from the calendar of 10-27-47 at Cincinnati, Ohio. All said motions denied. Motion of petitioner to strike 184-R from the calendar of Oct. 27, 1947 at Cincinnati, Ohio filed at hearing—10-10-47 copy served.

2 1947

Oct. 8—Order that motion to consolidate is denied and motion to defer entry of decision. Dockets 9461 and 9462 is denied and motion to strike docket 184-R from trial calendar of 10-27-47 is denied entered.

Oct. 14—Answer to petition and amendment to petition filed by General Counsel.

Oct. 14—Request for hearing at Cincinnati, Ohio, filed by General Counsel.

Oct. 21—Notice issued placing proceeding on Cincinnati calendar. Service of answer and request made.

Nov. 28—Reply to answer filed by taxpayer—copy served.

Nov. 28—Motion to advance cause for early hearing filed by taxpayer. 12-4-47 granted.

2 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

1948

Jan. 14—Hearing set 3-1-48 at Cincinnati, Ohio.

Mar. 1—Hearing had before Judge LeMire on merits.

Stipulation of facts filed. Briefs due 3-31-48—
replies 4-15-48.

Mar. 13—Transcript of hearing 3-1-48 filed.

Mar. 31—Brief filed by General Counsel.

Apr. 12—Motion for leave to file brief out of time filed by taxpayer.

Apr. 12—Order that the brief is withdrawn in docket 9461; that the Clerk shall remove first and fourth pages of brief and shall substitute new pages furnished by counsel bearing caption of the proceeding at docket 15836 and further ordered that petitioner's motion at docket 15836 is granted and aforesaid brief with pages substituted as directed shall be filed in docket 15836, entered.

Apr. 12—Brief filed by taxpayer. 4-13-48 copy served.

Aug. 16—Opinion rendered LeMire, J. Decision will be entered under Rule 50.

Aug. 24—Computation for entry of decision filed by taxpayer. 8-30-48 served.

Aug. 27—Hearing set Sept. 22, 1948 on petitioner's computation. 8-30-48 copy served.

3 1948

Sept. 8—Computation for entry of decision filed by General Counsel.

Sept. 15—Ordered continued to Sept. 29, 1948 at Washington, D. C. on settlement under Rule 50, entered.

Sept. 29—Hearing had before Judge LeMire on settlement under Rule 50. C. A. V. Memorandum briefs Oct. 18, 1948.

Oct. 5—Transcript of hearing of 9-29-48 filed.

Oct. 21—Brief re computation filed by taxpayer. 10-27-48 copy served.

Oct. 26—Decision entered LeMire, J., Div. 14.

1949

Jan. 19—Petition for review by U. S. Court of Appeals for the Circuit filed by General Counsel.

Jan. 25—Notice of filing petition for review sent to Sol Goodman, attorney for taxpayer, filed.

Feb. 1—Proof of service of petition for review filed. (Taxpayer)

Feb. 1—Proof of service of petition for review filed. (Counsel)

Feb. 18—Motion for extension to April 19, 1949 to prepare and transmit record filed by General Counsel.

- Feb. 18—Order enlarging time to April 19, 1949 to prepare and transmit record entered.
- Apr. 13—Certified copy of an order from 6th Circuit extending time to June 19, 1949 to file record on review filed.
- June 27—Certified copy of an order from 6th Circuit extending time to August 19, 1949 to file record on review filed.
- Aug. 4—Statement of points with proof of service thereon filed by General Counsel.
- Aug. 4—Designation of contents of record with proof of service thereon filed by General Counsel.

In the Tax Court of the United States

Petition, filed September 15, 1947

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency bearing Bureau symbols Cin.D:SN:DAR, dated September 4th, 1947, and, as a basis of his proceeding, alleges as follows:

1. The petitioner is an individual with residence at R. R. No. 4, Batavia, Ohio. The tax return here involved was filed with the Collector of Internal Revenue for the Southern District of Ohio.
2. The notice of deficiency (a copy of which is hereto attached and marked Exhibit "A") was mailed to the petitioner on September 4th, 1947. There is also attached hereto and marked Exhibit "B", a copy of the report of the agent dated August 15th, 1947.
3. The taxes in controversy are income taxes for the calendar year 1943, in the amount of \$422.20, and for the year 1944, no change, and the disallowance of a claim for refund of \$46,864.00, all of said amounts being in dispute.
4. The determination of tax set forth in said notice of deficiency is based upon the following errors, to-wit: There is no deficiency due and, on the contrary, there has been an overpayment in income taxes for the years 1942, 1943 and 1944, in the amount of \$59,488.25.
5. The facts upon which the petitioner relies as a basis of this proceeding are, as follows:
 - (a) The deficiency set up is based upon the disallowance of the payment of real estate taxes which were due and payable after petitioner acquired the real estate and are proper deductions for the year 1943.
 - (b) The facts upon which the petitioner relies as a basis for this proceeding, as to his claim for refund heretofore filed, in the amount of \$46,864.00, and a redetermination of the tax liability entitling him to a credit or refund for said years of a total amount of \$59,488.25, are as follows:

4. COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

(c) Petitioner states that the Charles E. Smith and Sons Company is a corporation organized under the laws of the State of Ohio in the year 1904, with an office and place of business in Cincinnati, Ohio; that, during the taxable fiscal years of said corporation, ending July 31, 1942 and 1943, he was then the president of said corporation and owner of all of its capital stock.

(d) Petitioner states that, in the year 1941, said corporation fixed petitioner's salary at \$52,000.00 per annum for the fiscal year ending July 31, 1942, and for the fiscal year ending July 31, 1943, said corporation fixed petitioner's salary at 15% of its sales but no less than \$52,000.00 per annum, which salary in said year amounted to \$87,265.08.

(e) Petitioner states that, during the taxable years 1942 and 1943, he had invested in said corporation the sum of \$30,000.00 in its capital stock and that about the month of September, 1942, he was paid on account of his salary the sum of \$30,000.00, which amount he immediately paid back to the corporation and took 300 shares of its stock for an additional \$30,000.00, thus making petitioner's investment in said corporation amount to \$60,000.00; that, in January, 1943, petitioner returned said 300 shares of stock to said corporation in exchange for \$30,000.00.

(f) Petitioner states that the Commissioner of Internal Revenue, in reviewing the income tax returns of said corporation, made a determination that, for the fiscal year 1942, the reasonable salary to be paid to petitioner was \$25,000.00; that for the fiscal year 1943, the reasonable salary to be paid to petitioner was the sum of \$30,000.00; and determined that petitioner received excessive salary in the amount of \$27,000.00 for the fiscal year 1942 and \$57,265.08 for the fiscal year 1943, and by reason thereof assessed additional taxes against said corporation in the amount of \$110,909.92 for the fiscal year 1943 and \$7,980.95 for the fiscal year 1942. Petitioner states that by reason of said additional assessments, it was then determined that said corporation was insolvent, as of July 31, 1943, having liabilities of \$207,912.63 as against assets of \$173,525.24, and by reason thereof, petitioner was held liable as transferee and there has been asserted against petitioner a transferee liability in the amount of \$87,265.06.

(g) Petitioner states that when he received said salaries for the year 1942, he reported said \$52,000.00 as income and there was determined a tax due thereon in the amount of \$23,884.81. Petitioner further states that for the year 1943, he reported said \$87,265.08 as income and there was determined a tax due thereon in the amount of \$53,517.05; that by reason of the forgiveness feature of the income tax law applicable to the years 1942 and 1943, instead of paying the total of said two amounts, petitioner's

total tax for the year 1943, including a portion of the amount of tax for which he was liable for the year 1942, amounted to \$59,488.25.

(h) Petitioner states that by reason of the claims of the respondent and the decision of the Tax Court of the United States, in cause No. 9461 and Cause No. 9462, it has been determined that the amount of salary actually receivable by the petitioner was \$25,000.00 for the year 1942 and \$30,000.00 for the year 1943, and that any excess amount petitioner is required to return to the account of said corporation to apply for the payment of its taxes. Petitioner states that by reason of said determination and decision and the requirement and petitioner return said excessive salary, the correct amount of tax due from petitioner for said years should be reduced and by reason thereof petitioner's total liability for tax was \$12,624.25 for said two years, and there is due petitioner a refund of \$46,864.00.

(i) Petitioner states that, in the year 1941, he paid \$30,000.00 for 300 shares of the stock of said Charles E. Smith and Sons Company and, in the year 1942, he paid \$30,000.00 for an additional 300 shares of stock in said Charles E. Smith and Sons Company; that on January 7, 1943, he returned the 300 shares of said stock to said corporation in exchange for \$30,000.00. This Court, in Cause No. 9461 and Cause No. 9462, having found that the receipt by petitioner of said \$30,000.00 for said stock made petitioner liable as transferee for Charles E. Smith and Sons Company. By reason of said facts, the payments of salary of \$25,000.00 for the year 1942 and \$30,000.00 for the year 1943, which salaries respondent determined reasonable, were not as a matter of fact received by petitioner as reported by petitioner in his income tax return but, in fact, constituted a return of his capital investment in said corporation and was not subject to income tax.

(j) Petitioner therefore claims that the total amount of tax of \$59,488.25 which he paid for the years 1942 and 1943 was improperly paid and that the total amount of said tax should be refunded to him, and that when the petitioner filed his claim for refund at said time, said respondent had only asserted a transferee liability on the portion of excessive salaries paid petitioner by the corporation and since then this Court having found that petitioner is also liable on the disbursement in exchange for stock, petitioner therefore received no income from said corporation for said years and is entitled to a refund of said amount of \$59,488.25.

Wherefore, petitioner prays that this Court may hear the proceedings and redetermine the amount of tax due from petitioner and make an award ordering the respondent to make a refund

6 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH
8 to the petitioner of the amount of \$59,488.25, and for any
and all other relief that is proper in such cases.

SOL GOODMAN,
1016 Union Trust Building, Cincinnati, Ohio,
Attorney for Petitioner.

Duly sworn to by Hall C. Smith jurat omitted in printing.

9 Exhibit A to petition

TREASURY DEPARTMENT

INTERNAL REVENUE SERVICE

Cincinnati 1, Ohio

In reply refer to CinD:SN:DAR-mec.

Mr. HALL C. SMITH,
R. R. No. 4, Batavia, Ohio.

DEAR MR. SMITH: You are advised that the determination of your income tax liability for the taxable year ended December 31, 1943, discloses a deficiency of \$422.20, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Cincinnati, Ohio, for the attention of CinD:SN:DAR. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

10 Very truly yours,

GEORGE J. SCHOENEMAN,
Commissioner,

By (S) H. D. EVANS,
Internal Revenue Agent in Charge.

Enclosures:
Statement
Waiver Form 870

COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

7

STATEMENT

Mr. HALL C. SMITH, R. R. No. 4, Batavia, Ohio.

INCOME TAX LIABILITY FOR THE TAXABLE YEAR ENDED
DECEMBER 31, 1943

Year
1943

Deficiency
\$422.20

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 30, 1947, and to your claim for refund for the year 1943, filed January 15, 1947.

If a petition to the Tax Court of the United States is filed against the deficiency proposed herein, the issue set forth in your claim for refund should be made a part of the petition to be considered by the Tax Court in any redetermination of your tax liability. If a petition is not filed, the claim for refund will be disallowed and official notice will be issued by registered mail in accordance with section 3772 of the Internal Revenue Code.

11 ADJUSTMENTS TO INCOME TAX NET INCOME

Year ended December 31, 1943

Income tax net income disclosed by return	\$84,207.90
Unallowable deductions and additional income:	
(a) Taxes on rental property	499.66
Income tax net income adjusted	84,707.56

EXPLANATION OF ADJUSTMENTS TO INCOME TAX NET INCOME

(a) It is held that real estate taxes on your rental property in the amount of \$499.66, which had accrued prior to the date of purchase of such property, does not constitute an allowable deduction in accordance with the provisions of section 23 of the Internal Revenue Code.

ADJUSTMENT TO VICTORY TAX NET INCOME

Year ended December 31, 1943

Victory tax net income disclosed by return	\$84,456.95
Unallowable deductions and additional income:	
(a) Taxes on rental property	499.66
Total	84,956.61
Nontaxable income and additional deductions:	
(b) Intangible Tax	150.00
Victory tax net income adjusted	84,806.61

8 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH
EXPLANATION OF ADJUSTMENTS TO VICTORY TAX NET INCOME

(a) The real estate taxes accrued prior to the purchase of your rental property do not constitute an allowable deduction, as explained hereinbefore.

(b) It is held that you are entitled to an additional deduction of \$150.00 for intangible tax on your property, in accordance with the provisions of section 451 (a) of the Internal Revenue Code.

NOTE—As to page 4—See page 4 of Exhibit "B."

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Exhibit B to petition

In re: Hall C. Smith, R. R. No. 4, Batavia, Ohio.

— 1 —

Examining Officer
Wm. Sarenok, Jr.

Date of Report
July 30, 1947

INDEX

Pages: 5
Schedules: 4

PRELIMINARY STATEMENT

SUMMARY

Years	Deficiency
1943	\$422.20 and disallowance of claim for refund.
1944	No change.

Additional tax: \$422.20.

Principal cause of the deficiency: Disallowance of real estate taxes paid in 1943 upon property purchased in 1943.

The findings were discussed with taxpayer and Mr. Sol Goodman, attorney.

Other necessary information:

Claim for refund No.

Year involved

Date of Claim

Amount of claim

Amount of claim allowed

Amount of claim disallowed

1943

1-15-47

\$46,864.00

0

\$46,864.00

Taxpayer claims that amount of salary received from Charles E. Smith & Sons Co., 1942—\$52,000.00; 1943—\$87,265.08 considered excessive and only the amount allowed as deduction to corporation by Tax Court, 1942—\$25,000.00; 1943—\$30,000.00 should be considered his income for taxable years involved.

13

The claim is disallowed in full because taxpayer had full use of salary received by him in each year.

-2-

SCHEDULE No. 1

Year ended 12-31-42

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return	\$48,608.42
As corrected	48,608.42
Net adjustment as computed below	No Change

SCHEDULE No. 2

Year ended 12-31-43

ADJUSTMENTS TO NET INCOME

	Income tax net income	Victory tax net income
Net income as disclosed by return	\$84,207.90	\$84,458.95
As corrected	84,707.56	84,808.61
Net adjustment as computed below	499.66	349.66
Unallowable deductions and additional income:		
(a) Rents		
Total	499.66	499.66
Nontaxable income and additional income:		
(b) Taxes		
Total	0	150.00
Net adjustment as above	0	150.00
	499.66	349.66

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-3-

SCHEDULE No. 2-A

Year ended 12-31-43

EXPLANATION OF ITEMS

(a) Rents (income tax and victory tax):	
Reported	\$1,808.72
Corrected	2,308.38
Difference	499.66

Taxpayer purchased two pieces of real estate as follows:

- I-2786 Observatory Avenue; deal closed 3-26-43.
- II-3237 Griest Avenue; deal closed 3-16-43.

In Ohio real estate taxes accrue on the day preceding the second Monday in April; though assessment is not made until December.

10 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

The person who owns the property on the date the taxes accrue under State Law is entitled to the deduction (if he pays the tax).

During 1943 taxpayer paid following 1942 taxes which had previously accrued on the property—a lien at time of purchase.

I—\$190.14

II—\$309.52

499.66

Both of these items are not allowable deductions. Further these taxes were an adjustment in purchase price of property—reduced amount of cash taxpayer had to pay for the property. The disallowed tax item is not to be added to cost of property, because it has already been allowed as part of cost.

(b) Taxes (victory tax):

Reported	-----	\$ 0
Corrected	-----	150.00
Difference	-----	150.00

15 Hamilton County Intangible (Personal Property) Tax is an allowable deduction in computing victory tax net income.

— 4 —

SCHEDULE No. 3

Year ended 12-31-43

COMPUTATION OF INCOME AND VICTORY TAX

CURRENT TAX PAYMENT ACT OF 1943

1. Income tax net income, from Schedule No. 2	-----	\$84,707.56
2. Less: Personal exemption	-----	\$1,200.00
Credit for dependents	-----	700.00
	-----	1,900.00
3. Surtax net income	-----	82,807.56
4. Less: Earned income credit	-----	1,400.00
	-----	81,407.56
5. Balance subject to normal tax	-----	4,884.45
6. Normal tax at 6 percent	-----	46,045.67
7. Surtax on item 3	-----	50,930.12
8. Total income tax (item 6 plus item 7)	-----	84,806.61
11. Victory tax net income	-----	624.00
12. Less: Specific exemption	-----	
	-----	84,182.61
13. Income subject to victory tax	-----	4,200.13
14. Victory tax before credit (5 percent of line 13)	-----	1,200.00
15. Less: Victory tax credit	-----	

COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH 11

16. Net victory tax	3,009.13
17. Net income tax and victory tax	53,939.25
18. Income tax for 1942 per original return	23,884.81
19. Amount of item 17 or 18 whichever is larger	53,939.25
16 20. Forgiveness feature:	
(a) Amount of item 17 or 18 which is smaller	\$23,884.81
(b) Amount forgiven (three-fourths of (a))	17,913.61
(c) Amount unforgiven	5,971.20
21. Total income and victory tax liability	59,910.45
22. Income and victory tax liability disclosed by return	59,488.25
23. Deficiency in income and victory tax	422.20

SCHEDULE No. 4

Year ended 12-31-44

EXPLANATION OF ITEMS

Net income reported (1944)	\$16,104.59
Income tax liability per return	4,777.30
No changes for year 1944.	

In the Tax Court of the United States

Amendment to Petition

Filed September 22, 1947.

Now comes the Petitioner herein and amends the petition heretofore filed by attaching a copy of the claim to said petition.

SOL GOODMAN,

1016 Union Trust Building, Cincinnati, Ohio,
Attorney for Petitioner.

Form 843
 TREASURY DEPARTMENT
 Internal Revenue Service
 (Revised April 1940)

CLAIM

To be filed with the Collector where assessment was made or tax paid.

The collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse side.

Collector's Stamp
 (Date received)

- ☐ REFUND OF TAX ILLEGALLY COLLECTED.
- ☐ REFUND OF AMOUNT PAID FOR STAMPS UNUSED, OR USED IN ERROR OR EXCESS.
- ☐ ABATEMENT OF TAX ASSESSED (not applicable to estate or income taxes).

STATE OF OHIO,
 COUNTY OF HAMILTON } ss:

TYPE
 OR
 PRINT

Name of taxpayer or purchaser of stamps: Hall C. Smith.

Business address:

Residence: R. R. No. 4, Batavia, Clermont County, Ohio.

The Deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below are true and complete:

1. District in which return (if any) was filed: Cincinnati, Ohio.
2. Period (if for income tax, make separate form for each taxable year) from January 1, 1943, to Dec. 31, 1943.
3. Character of assessment or tax: Income tax.
- 18 4. Amount of assessment: \$59,488.25; dates of payment: May 18, 1944.
5. Dates stamps were purchased from Government:
6. Amount to be refunded: \$46,864.00.
7. Amount to be abated (not applicable to income or estate taxes):
8. The time within which this claim may be legally filed expires, under Section ---- of the Revenue Act of 1943, on March 15, 1947.

The deponent verily believes that this claim should be allowed for the following reasons:

The deponent paid income tax for the year 1943 in the amount of \$59,488.25, being computed upon salary received from Charles E. Smith & Sons Co. in the year 1942, \$52,000, and the year 1943, \$87,265.08. In cases numbers 9461 and 9462 pending in The Tax Court of the United States, the Commissioner of Internal Revenue contends that a reasonable salary for deponent for the year 1942 was \$25,000 and for the year 1943 was \$30,000. The Commissioner seeks to recover the excess over and above those amounts from deponent as transferee. If it is finally determined that the salaries paid were not reasonable compensation and were received by deponent embraced with a trust in favor of the Government and subject to transferee liability, then deponent is entitled to a refund for income taxes paid on such claimed excessive portion in the amount of the difference of the tax he paid and the tax which would be due amounting to \$12, 624.25, entitling deponent to a refund of \$46,864.00.

(Signed) HALL C. SMITH.

Sworn to and subscribed before me this 16th day of January, 1947.

CLARA L. FATH.

19 . In the Tax Court of the United States

Answer to petition and to amendment to petition

Filed October 14, 1947

Comes now the Commissioner of Internal Revenue by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition and to the amendment to petition filed herein, admits, denies and alleges as follows:

1. Admits the allegations contained in paragraph 1 of the petition.
2. Admits that the notice of deficiency was mailed to the petitioner on September 4, 1947, but denies that Exhibit "A" attached to the petition is a true copy thereof. Alleges that Exhibit 1 attached hereto is a true copy of said notice of deficiency.
3. Admits that the taxes in controversy are income taxes for the calendar year 1943 in the amount of \$422.20. Denies the remaining allegations contained in paragraph 3 of the petition.
4. Denies that respondent erred in his determination of the deficiency as shown by the notice of deficiency from which petitioner's appeal is taken; specifically denies that in the determina-

16 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

SN:DAR. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

GEORGE J. SCHOENEMAN,
Commissioner,

By (S) H. D. EVANS,
Internal Revenue Agent in Charge.

Enclosures:

Statement
Waiver Form 870

STATEMENT

Mr. Hall C. Smith, R. R. No. 4, Batavia, Ohio.

INCOME TAX LIABILITY FOR THE TAXABLE YEAR ENDED

December 31, 1943

Year	Deficiency
1943	\$422. 20

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 30, 1947, and to your claim for refund for the year 1943, filed January 15, 1947.

If a petition to the Tax Court of the United States is filed against the deficiency proposed herein, the issue set forth in your claim for refund should be made a part of the petition to be considered by the Tax Court in any redetermination of your tax liability. If a petition is not filed, the claim for refund will be disallowed and official notice will be issued by registered mail in accordance with section 3772 of the Internal Revenue Code.

24 ADJUSTMENTS TO INCOME TAX NET INCOME

Year ended December 31, 1943

Income tax net income disclosed by return	\$84, 207. 90
Unallowable deductions and additional income:	
(a) Taxes on rental property	499. 66
Income tax net income adjusted	84, 707. 56

EXPLANATION OF ADJUSTMENTS TO INCOME TAX NET INCOME

(a) It is held that real estate taxes on your rental property in the amount of \$499.66, which had accrued prior to the date of

purchase of such property, does not constitute an allowable deduction in accordance with the provisions of section 23 of the Internal Revenue Code.

ADJUSTMENTS TO VICTORY TAX NET INCOME

Year ended December 31, 1943

Victory tax net income disclosed by return	\$84,456.95
Unallowable deductions and additional income:	
(a) Taxes on rental property	499.66
Total	84,956.61
Nontaxable income and additional deductions:	
(b) Intangible Tax	150.00
Victory tax net income adjusted	84,806.61

EXPLANATION OF ADJUSTMENTS TO VICTORY TAX NET INCOME

(a) The real estate taxes accrued prior to the purchase of your rental property do not constitute an allowable deduction, as explained hereinbefore.

(b) It is held that you are entitled to an additional deduction of \$150.00 for intangible tax on your property, in accordance with the provisions of section 451 (a) of the Internal Revenue Code.

25 COMPUTATION OF INCOME AND VICTORY TAX

Year ended December 31, 1943

1. Income tax net income adjusted	\$84,707.56
2. Less: Personal exemption	\$1,200.00
Credit for dependents	700.00
	<u>1,900.00</u>
3. Balance (surtax net income)	82,807.56
4. Less: Earned income credit	1,400.00
5. Balance subject to normal tax	81,407.56
6. Normal tax at 6% of \$81,407.56	4,884.45
7. Surtax on \$82,807.56	46,045.67
8. Total income tax	50,930.12
9. Victory tax net income adjusted	84,806.61
10. Less: Specific exemption	624.00
11. Income subject to victory tax	84,182.61
12. Tentative victory tax (5% of \$84,182.61)	4,209.13
13. Less: Victory tax credit	1,200.00
14. Net victory tax	3,009.13

15. Net income and victory tax liability-----	\$53,939.25
16. Income tax for 1942 per return-----	23,884.81
17. Item 15 or item 16, whichever is larger-----	53,939.25
18. Forgiveness features:	
(a) Item 15 or item 16, whichever is smaller--	\$23,884.81
(b) Amount forgiven, $\frac{3}{4}$ of item (a)-----	17,913.61
	<hr/> 5,971.20
19. Total income and victory tax liability-----	59,910.45
20. Income and victory tax liability disclosed by re-	
turn: Original, Account No. 359050-----	59,488.25
Deficiency-----	<hr/> 422.20

In the Tax Court of the United States

26

Reply to answer

Filed November 28, 1947

Comes now the petitioner and for reply to the answer herein admits, denies and alleges, as follows:

1. In paragraph 2 of its answer, respondent alleges that Exhibit 1, attached thereto, is a true copy of said notice of deficiency. In paragraph 3 of said answer, respondent denies the allegation contained in paragraph 3 of the petition, wherein petitioner set forth that the deficiency notice included the disallowance of a claim for refund of \$46,864.00. In Exhibit 1, attached to respondent's answer, on the second page thereof, it is shown as follows:

"If a petition to the Tax Court of the United States is filed against the deficiency proposed herein, the issue set forth in your claim for refund should be made a part of the petition to be considered by the Tax Court in any redetermination of your tax liability."

Petitioner therefore alleges that the matter of the denial of the claim for refund is in issue herein.

2. Petitioner denies the allegations contained in paragraph 5 (f) of said answer that the determination holding that he had received \$57,265.08 in excessive salary for the years 1942 and 1943, and that, together with \$30,000 paid by the corporation to the petitioner in redemption of its stock, it resulted in petitioner becoming liable as transferee to the extent of \$87,265.08. Petitioner states, however, that on October 27, 1947, the Tax Court revised its prior opinion and held that petitioner's liability was limited to \$57,265.08.

3. For further reply, petitioner specifically denies each and every allegation contained in the answer of respondent, excepting

only such allegations which contain facts that were set forth in the petition and in this reply.

Wherefore, petitioner prays the Court for relief as in his petition.

SOL GOODMAN,
1016 Union Trust Building, Cincinnati, Ohio,
Attorney for Petitioner.

27 *Duly sworn to by Hall C. Smith jurat omitted in printing.*

In the Tax Court of the United States

Stipulation of facts

Filed at hearing March 1, 1948

It is hereby stipulated and agreed by and between counsel for the respective parties that the facts hereinafter stated are true and correct and that this stipulation may be offered in evidence in the trial of this cause by either party with the same force and effect as if the same were duly proved by the testimony of witnesses, reserving to each party the right to offer any additional testimony on any or all of the matters covered in this stipulation not inconsistent with any of the facts stated herein, in accordance with the rules of The Tax Court of the United States.

1. The petitioner, Hall C. Smith, is an individual residing in Batavia, Ohio. During the fiscal years ended July 31, 1942 and July 31, 1943 petitioner was the president and sole owner of the corporate stock of The Charles E. Smith & Sons Company, 28 (hereinafter referred to as the company), a corporation organized under the laws of the State of Ohio, and doing business in Cincinnati, Ohio.

2. In March of 1943 petitioner purchased two parcels of real property in Cincinnati, Ohio, and as part of said purchase agreed to and did pay to the State of Ohio the amount of \$499.66 in satisfaction of liens for taxes for the calendar year 1942, which, under the provisions of section 5671 of the Ohio Code, attached to said property on the day preceding the second Monday of April 1942. The disallowance by respondent of this payment as a deduction from petitioner's 1943 gross income in determining taxable income for said year is the sole adjustment producing the deficiency here in controversy.

3. The company paid petitioner a salary of \$52,000 for his services during the fiscal year ended July 31, 1942. All of this salary was paid during the period commencing August 1, 1941 and ending September 15, 1942. The company paid petitioner a salary of \$87,265.08 for his services during the fiscal year ended

July 31, 1943. All of this salary was paid during the period beginning August 1, 1942, and ending September 1, 1943.

4. The company deducted the amounts of salary referred to in paragraph 3, supra, from income in its Federal income and declared value excess-profits tax returns filed for the fiscal years ended July 31, 1942 and July 31, 1943, respectively. The Commissioner of Internal Revenue determined that said amounts of salary exceeded a reasonable allowance for compensation for services actually rendered by petitioner to the company, to the extent of \$27,000 for the 1942 and \$57,265.08 for 1943, and, further, that to the extent thereof petitioner was liable as transferee, under the provisions of section 311 of the Internal Revenue Code, for the companies deficiencies in Federal income, declared value excess-profits and excess profits taxes for the fiscal years ended July 31, 1942 and July 31, 1943.

5. The said company and the petitioner each filed petitions with the Tax Court of the United States for redetermination of the proposed deficiencies resulting from the aforesaid adjustments by the Commissioner of Internal Revenue as set forth in paragraph 4, supra, and on May 12, 1947, the Tax Court promulgated its consolidated opinion, which was modified by order of the Tax Court entered October 28, 1947, wherein the action of the Commissioner in disallowing the foresaid portions of salaries paid to Hall C. Smith as excessive compensation was sustained in its entirety, and in the case of Hall C. Smith the Court held that he was liable as transferee of the said Charles E. Smith & Sons Company for the aforesaid years ending July 31, 1942 and July 31, 1943, to the extent of \$57,265.08. Rule 50 recomputations in both proceedings have been prepared and filed with the Tax Court. However, the Court has not as yet entered its final order in either proceeding. No part of the aforesaid amount of \$57,265.08 has as yet been paid by petitioner, Hall C. Smith, as transferee of the said company.

6. The petitioner included the salaries referred to in paragraph 3, supra, in his income tax returns filed for the calendar years 1942 and 1943. The tax liability disclosed by said returns to be due for the calendar year 1943 was paid by petitioner at various times, through withholding by the company, payment on 1942 income, payments on account of Declaration of Estimated Tax, and the balance on or about the date of filing of his 1943 return.

7. The petitioner received the salaries referred to in paragraph 3, supra, under a claim of right and has ever since retained said amount of salaries, and had no knowledge of the proposed disallowance of said salaries as a deduction to said company until September of 1944.

8.. On January 15, 1947, petitioner filed with the Collector of Internal Revenue at Cincinnati, Ohio, a claim for refund of a portion of the income tax paid on the salaries referred to in paragraphs 3 and 6, *supra*. A copy of said claim is attached to the petition. This claim was denied by the Commissioner of Internal Revenue in the notice of deficiency referred to in paragraph 9 herein.

30 9. The notice of deficiency attached to respondent's answer in this proceeding, as Exhibit 1, is a true and correct copy of the notice of deficiency upon which this petition is based.

SOL GOODMAN,
Counsel for Petitioner.
 (Sgd.) CHARLES OLIPHANT, WWK
Chief Counsel,
Bureau of Internal Revenue, Counsel for Respondent.

In the Tax Court of the United States

11 T. C. No. 25

HALL C. SMITH, PETITIONER, V. COMMISSIONER OF INTERNAL
 REVENUE, RESPONDENT

Docket No. 15836. Promulgated August 16, 1948

In a prior proceeding in this Court the petitioner was held liable, in equity, as a transferee for unpaid taxes of a corporation of which he was sole stockholder and president, to the extent of the salary paid to him in 1943, when the corporation was insolvent, in excess of reasonable compensation for services rendered. Held, that such excessive salary was received by the petitioner in trust for the benefit of the corporation's creditors and is therefore not taxable to the petitioner in his individual income tax return.

Sol Goodman, Esq., for the petitioner.

John O. Durkan, Esq., for the respondent.

31

Opinion

LEMIRE, Judge: The respondent has determined a deficiency in petitioner's income tax for 1943 in the amount of \$422.20. The petitioner claims an overpayment of \$46,864 in his tax for that year. The deficiency results from the disallowance of the deduction of real estate taxes which had accrued prior to the date of petitioner's purchase of property. The claim for refund, which has been disallowed in full by the respondent, involves the petitioner's liability for tax on a portion of the compensation paid to him in the taxable year by a corporation of which he was presi-

dent and sole stockholder. The respondent determined, and was sustained by this Court, that a portion of such compensation was excessive and that to the extent of such excess the petitioner was liable as transferee for the unpaid taxes due from the corporation.

The parties have submitted a stipulation of facts which we adopt as our findings of fact herein. These facts may be summarized as follows:

The petitioner is a resident of Batavia, Ohio. He filed his return for the taxable year involved with the collector of internal revenue for the southern district of Ohio. During 1942 and 1943 the petitioner was the president and sole stockholder of The Charles E. Smith & Sons Company. The company paid him a salary of \$52,000 for its fiscal year ended July 1, 1942, and \$87,265.08 for the year ended July 31, 1943. The 1942 salary was all paid to the petitioner over the period August 1, 1941, to September 15, 1942, and that for 1943 over the period August 1, 1942, to September 1, 1943.

The salary so paid to the petitioner was deducted by the company in its income and declared value excess-profits tax returns for the respective years but the respondent determined that it exceeded a reasonable compensation for the services rendered by the petitioner to the extent of \$27,000 in 1942 and \$57,265.08 in 1943. The respondent further determined that to the extent of such excessive salary the petitioner was liable as transferee for the unpaid taxes of the company.

32 The company and the petitioner each filed a petition to this Court. In the action brought by the company, Docket No. 9461, we sustained the Commissioner's disallowance of a portion of the petitioner's salary for both 1942 and 1943, and in the transferee proceeding, Hall C. Smith, Transferee, Docket No. 9462, we found the petitioner not liable in respect of the compensation paid to him for 1942, since there was no proof that the company was insolvent when the salary for that year was paid, but liable in respect of the excessive 1943 salary to the full extent thereof for the payment of company taxes for 1942 and 1943. Decisions in both proceedings were entered May 28, 1948.

The petitioner reported all of the salary paid to him by the company in 1942 and 1943 and paid the tax shown to be due thereon. On January 15, 1947, the petitioner filed with the collector of internal revenue at Cincinnati, Ohio, a claim for refund of \$46,864 of the \$59,488.25 tax which he had paid on his 1943 return. The claim was based on the petitioner's contention that he may not be taxed on the excessive salary which might be subject to transferee liability as finally determined. The claim for refund was disallowed by the respondent in the notice of deficiency herein.

It is stipulated that—

The petitioner received the salaries referred to in paragraph 3, *supra*, under a claim of right and has ever since retained said amount of salaries, and had no knowledge of the proposed disallowance of said salaries as a deduction to said company until September of 1944.

In March 1943 the petitioner purchased two parcels of real property located in Cincinnati, Ohio, and as a part of the purchase price thereof agreed to pay and did pay to the State of Ohio the amount of \$499.66 in satisfaction of liens for taxes for the calendar year 1942. Under the provisions of section 5671 of the Ohio Code the liens had attached to the property on the day preceding the second Monday in April 1942. The amount of taxes
33 so paid was claimed as a deduction by the petitioner in his 1943 return and was disallowed by the respondent in determining the deficiency.

The transferee liability with which section 311 (a) of the Internal Revenue Code deals is liability either "at law or in equity." Liability at law is commonly based upon the contractual obligation, as where one corporation acquires the assets of another and agrees to pay the taxes of the transferor. Liability in equity is said to rest upon the trust fund doctrine; that is, the transferee receives assets from the transferor impressed with a trust for the benefit of the transferor's creditors. See *Pierce v. United States*, 255 U. S. 398; *Phillips v. Commissioner*, 283 U. S. 589; *Phillips-Lones Corporation v. Parmley*, 302 U. S. 233. In the last cited case the Court said:

The liability of the stockholders for the taxes was not created by section 280. It does not originate in an assessment made thereunder. Long before the enactment it had been settled under the trust fund doctrine (see *Pierce v. United States*, 255 U. S. 398, 402, 403 * * *) that if the assets of a corporation are distributed among the stockholders before all its debts are paid, each stockholder is liable severally to creditors, to the extent of the amount received by him; and that as between all stockholders similarly situated the burden of paying the debts shall be borne ratably. * * *

The petitioner's transferee liability for the 1942 and 1943 taxes of the Charles E. Smith & Sons Company, as determined by this Court in the proceeding referred to above, Docket No. 9462, was found to have resulted from the distributions made to him by the company in the year 1943, when the company was insolvent, in excess of reasonable compensation for services rendered. Thus, the transferee liability was a liability in equity resulting from the distributions to him of assets of the insolvent transferor without adequate consideration. The correctness of the

34 Tax Court's determination in the transferee proceeding is not attacked in this proceeding. The petitioner's only contention here is that since it has been determined by this Court that he is liable in equity as a transferee for the unpaid taxes of the transferor, to the extent of the full amount of excessive compensation distributed to him in the taxable year, such excessive salary may not be included in his taxable income.

We think that the petitioner must be sustained in this contention. The determination of this Court that the petitioner is liable in equity, as transferee, can mean only that he received the transferor's assets (the excessive compensation) impressed with a trust in favor of the Government's claim against the transferor for unpaid taxes. The petitioner held the funds not for himself but for the creditors of the transferor.

Since *Eisner v. Macomber*, 252 U. S. 189, the "use and benefit" theory has been accepted as a guiding principle in determining income tax liability. It has become almost axiomatic in our tax law that individual tax liability results only from the receipt of income, in money or the equivalent, for the taxpayer's beneficial use.

In *Commissioner v. Wilcox*, 327 U. S. 404, the Supreme Court said that "a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain." The Court further said that "the bare receipt of property or money wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of Section 22 (a)."

It was said in *Corliss v. Bowers*, 281 U. S. 376, that "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income."

Funds received in trust for the use and benefit of others are not income to the recipient. In *Parkview Memorial Association*, 34 B. T. A. 406, we said, speaking of amounts set aside for maintenance of a cemetery association, "If, however, there is a trust which the law recognizes, whether express or implied, and a pre-

35 scribed part of the contract price received for a lot can be said to be received in trust, such part is excluded from gross income." See also *Portland Cremation Association v. Commissioner*, 31 Fed. (2d) 843. The funds received by lessor as bonus money for an oil lease, which the lessor was legally obligated to pay over to the State of Texas, were held not taxable to the lessor in *Commissioner v. Turney*, 82 Fed. (2d) 661. The court there said: "Tax officials are not required to treat as income money received by a taxpayer when, under well-settled law, his receipt of

it has the effect of obligating him unconditionally to pay that money to another."

Park & Tilford, 43 B. T. A. 348, involved a situation somewhat analogous to that in the instant case. There the assets of two liquidating corporations designated A and B were distributed to two other corporate shareholders, Y and Z, which in turn liquidated and distributed their assets to the stockholders. We held that the unpaid taxes for corporations A and B, for which Y and Z were liable, should be taken into account in determining the transferee liability of the stockholders of Y and Z.

The instant case is distinguishable from cases like North American Oil Consolidated v. Burnet, 286 U. S. 417, dealing with the receipt of income "under a claim of right and without restriction as to its disposition." Here, there was a definite legal restriction of the petitioner's use of the excessive compensation which attached the moment that he received it. Such is the nature of a transferee liability.

There is obvious inconsistency, as well as injustice, in the respondent's position in seeking to tax the petitioner on income to which he, the respondent, has successfully laid claim on the ground that it was never the petitioner's income by right.

The petitioner's contention with respect to the deduction of real estate taxes paid in 1943 as a part of the purchase price of the property is rejected on authority of Pyramid Metals Co., 44 B. T. A. 1087, and cases therein cited.

Decision will be entered under Rule 50.

36

In the Tax Court of the United States

Decision

Entered October 26, 1948

Pursuant to the Court's Opinion, promulgated August 16, 1948, both parties filed computations which came on for hearing on September 29, 1948. Due consideration having been given thereto, it is

Decided that there is an overpayment of \$32,857.36 in income and victory tax for 1943, which overpayment was made within the limitations prescribed by section 322 (d) of the Internal Revenue Code.

Enter:

(SEAL)

(S) C. P. LEMIRE, Judge.

In the Tax Court of the United States

Petition for review

Filed January 19, 1949

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Sixth Circuit to review the decision entered by The Tax Court of the United States on October 26, 1948, deciding that "there is an overpayment of \$32,857.36 in income and victory tax for 1943, which overpayment was made within the limitations prescribed by section 322 (d) of the Internal Revenue Code." The respondent on review, Hall C. Smith, filed his individual income tax return for the calendar year 1942 and his individual income and victory tax return for the calendar year 1943 with the Collector of Internal Revenue for the First District of Ohio, whose office is located at Cincinnati, Ohio, and within the judicial circuit of the United States Court of Appeals for the Sixth Circuit, wherein this review is sought. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code. This
37 controversy involves Federal income and victory tax for the calendar year 1943.

(S) THERON L. CAUDLE, CAR
Assistant Attorney General,

(Signed) CHARLES OLIPHANT, CAR
Chief Counsel, Bureau of Internal Revenue, Attorneys
for Petitioner on Review.

In the Tax Court of the United States

Notice of filing petition for review

Filed February 1, 1949

To SOL GOODMAN, Esq.,
1016 Union Trust Building,
Cincinnati 2, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 19th day of January, 1949, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Sixth Circuit of the decision of this Court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 25th day of January, 1949.

VICTOR S. MERSCH,
Clerk, The Tax Court of the United States.

Service of copy of petition for review acknowledge this 29th day of January, 1949.

(S) SOL GOODMAN,
Counsel for Respondent on Review.

38

In the Tax Court of the United States

Notice of filing petition for review

Filed February 1, 1949

To Mr. HALL C. SMITH,
R. R. No. 4, Batavia, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 19th day of January, 1949, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Sixth Circuit of the decision of the Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 25th day of January, 1949.

(Signed) CHARLES OLIPHANT, AHF
*Chief Counsel, Bureau of Internal Revenue,
Counsel for Petitioner on Review.*

Service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 27th day of January, 1949.

(S) HALL C. SMITH,
Respondent on Review.

39

In the Tax Court of the United States

Statement of points

Filed August 4, 1949

Comes now the petitioner on review herein and makes this concise statement of points on which he intends to rely on the review herein, to-wit:

The Tax Court of the United States erred:

1. In holding that excessive compensation received by the taxpayer in the amount of \$57,265.08 may not be included in his taxable income.
2. In failing to uphold the action of the Commissioner in including in taxable income the excessive compensation received by the taxpayer in the amount of \$57,265.08.
3. In holding that there is an overpayment of \$32,857.36 in income and victory tax for 1943.

28 COMMISSIONER OF INTERNAL REVENUE VS. HALL C. SMITH

4. In failing to hold that there is a deficiency in income tax for the year 1943 in the amount of \$422.20.

5. In that its decision is contrary to law and regulations and is not supported by substantial evidence.

(S) THERON L. CAUDLE, CAR
Assistant Attorney General,

(Signed) CHARLES OLIPHANT, CAR
Chief Counsel, Bureau of Internal Revenue, Counsel for
Petitioner on Review.

Service of a copy of the within statement of points is hereby admitted this 2nd day of August, 1949.

(S) SOL GOODMAN,
1016 Union Trust Building, Cincinnati 2, Ohio,
Counsel for Respondent on Review.

40 Designation of contents of record on review (omitted in
printing)

41 Clerk's Certificate to foregoing transcript omitted in
printing.

In the Tax Court of the United States

Order enlarging time re record, February 18, 1949

Upon motion of counsel for the petitioner, it is
Ordered that the time for preparation, transmission and delivery of the record ^{sur} petition for review of the above-entitled proceeding in the United States Court of Appeals for the Sixth Circuit is extended to April 19, 1949.

(Signed) BOLTON B. TURNER,
Presiding Judge.

Dated: Washington, D. C., February 18, 1949.

A true copy.

Attest:

[SEAL]

VICTOR S. MERSCH,
Clerk,
The Tax Court of the United States.

42 In United States Court of Appeals, Sixth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER ON REVIEW,
v.

HALL C. SMITH, RESPONDENT ON REVIEW.

Order enlarging time re record

(Filed April 13, 1949)

Before: Hicks, Allen, and Miller, JJ.

For cause shown, it is ordered that the time within which to file the record on review in the above-entitled cause with this Court be, and the same is, extended to and including June 19, 1949.

It is further ordered, that the Clerk of this Court is directed to transmit to the Clerk of The Tax Court of the United States a certified copy of this order.

(S) XEN HICKS,
Chief Judge.

A true Copy.

Attest:

J. W. MENZIES,
Clerk, U. S. Court of Appeals
for the Sixth Circuit.

[SEAL]

By (S) MARY M. McAFEE,
Deputy Clerk.

43

In United States Court of Appeals

Order enlarging time re record

(Filed June 27, 1949)

For cause shown, it is ordered that the time within which to file the record on review in the above-entitled cause with this Court be, and the same is, extended to and including August 19, 1949.

It is further ordered, that the Clerk of this Court is directed to transmit to the Clerk of The Tax Court of the United States a certified copy of this order.

Done at Cincinnati, Ohio, this 21st day of June A. D. 1949,

(S) XEN HICKS,
U. S. Circuit Judge.

A true Copy.

Attest:

J. W. MENZIES,
Clerk, U. S. Court of Appeals
for the Sixth Circuit.

[SEAL]

By (S) MARY M. McAFEE,
Deputy Clerk.

PROCEEDINGS IN THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Cause Argued and Submitted

(Feb. 5, 1952—Before: Allen, Martin & McAllister, JJ.)

This cause is argued by Graham Loving, Jr. for petitioner and Sol Goodman for respondent and is submitted to the court.

Judgment

(Filed: Feb. 12, 1952)

This case came on to be heard on the record and briefs and oral argument of counsel.

And it appearing that the Tax Court of the United States, in a prior proceedings, held the respondent liable in equity as a transferee for unpaid taxes of a corporation, and that the decision of the Tax Court was affirmed by this court in *Smith v. Commissioner*, 184 Fed. (2nd) 1011, cert. denied, 340 U.S. 953;

And it appearing that the receipt of the excessive salary to the extent of which the respondent was held liable as transferee constituted "the bare receipt of property or money wholly belonging to another," *Commissioner v. Wilcox*, 327 U.S. 404, and that the respondent held the funds not for himself but for the creditors of the transferor;

It is ordered that the decision of the Tax Court be, and it hereby is, affirmed.

Petition for Rehearing

(Filed: March 1, 1952)

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 10979

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH, RESPONDENT

*On Petition for Review of the Decision of the Tax Court of the
United States***Petition of the Petitioner for Rehearing**

On February 12, 1952, this Court, relying upon the decision of the Supreme Court in the case of *Commissioner v. Wilcox*, 327 U. S. 404, affirmed *per curiam*, the decision of the Tax Court in this case. The Tax Court had held that salaries paid to the taxpayer in 1943, which were later determined to be excessive and therefore to the extent of which the taxpayer was liable as transferee for the taxes of his employer by reason of the employer's insolvency, were not income in 1943.

Since the date of this Court's decision in this case, the Court of Appeals for the Second Circuit on February 15, 1952; held in the cases of *Commissioner v. Hartfield* and *Commissioner v. Healy*, which presented the identical issue presented in the instant case, that the excessive salaries to the full amount received were income in the year of receipt thus reversing the Tax Court on the question involved.

In addition, at this time the Supreme Court is considering the case of *United States v. Rutkin*, 189 F.2d 431 (C.A. 3d), in which

appeal the *Wilcox* decision is directly involved. This case was argued during the week of December 3, 1951, and decision is expected shortly.

In view of this situation, and in order, if possible, to avoid the costly and perhaps unnecessary procedure of presenting this case to the Supreme Court by reason of the present conflict between this Court and the Court of Appeals of the Second Circuit, the petitioner on appeal respectfully petitions this Court for rehearing as to its decision in this matter.

This petition is presented in good faith and not for delay.

Respectfully submitted,

ELLIS N. SLACK,
Acting Assistant Attorney General.

A. F. PRESCOTT,
GRAHAM LOVING, JR.,
Special Assistants to the Attorney General.

FEBRUARY, 1952

Order Denying Petition for Rehearing

(Filed: April 11, 1952)

The petition for rehearing is denied.

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

I, CARL W. REUSS, Clerk of the United States Court of Appeals for the Sixth Circuit, do hereby certify that the foregoing is a true and correct copy of record and proceedings in the case of

COMMISSIONER OF INTERNAL REVENUE

VS.

HALL C. SMITH

No. 10,979, as the same remains upon the files and records of said United States Court of Appeals for the Sixth Circuit, and of the whole thereof.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed the seal of said Court at the City of Cincinnati, Ohio, this 19th day of May, A. D. 1952.

CARL W. REUSS,
*Clerk of the United States Court of Appeals
for the Sixth Circuit.*

SEAL

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Supreme Court of the United States

No. 138, October Term, 1952

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH

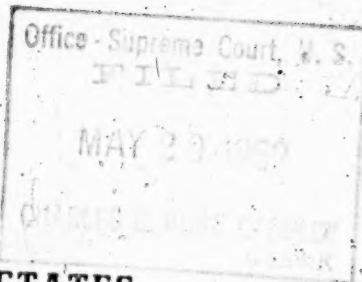
Order allowing certiorari

(Filed October 13, 1952)

The petition herein for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit is granted. The case is transferred to the summary docket and assigned for argument immediately following No. 76, Healy et al. vs. Commissioner of Internal Revenue.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1952

No. 787-76

EDWIN E. HEALY AND GORDON W. HARTFIELD,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SECOND CIRCUIT AND BRIEF IN SUPPORT
THEREOF.

FRANK J. MAGUIRE,
Counsel for Petitioners.

JAMES H. HEFFERN,
Of Counsel.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1951

No. 787

EDWIN E. HEALY AND GORDON W. HARTFIELD,
Petitioners,
vs.

COMMISSIONER OF INTERNAL REVENUE

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SECOND CIRCUIT AND BRIEF IN SUPPORT
THEREOF.**

*To the Honorable Chief Justice and Associate Justices of
the Supreme Court of the United States:*

Petitioners pray that a writ of certiorari issue to review the decision of the Court of Appeals for the Second Circuit entered on February 15, 1952 reversing the determination of the Tax Court of the United States entered March 14, 1951.

Opinions Below

The opinion of the Tax Court of the United States is reported in 16 T. C. 200 and the opinion of the United States Court of Appeals is reported at 194 F. 2d 662.

Basis of Jurisdiction

Jurisdiction is invoked under USC Title 28, section 1254 (1) and section 1141 (a) of the Internal Revenue Code.

This decision of the United States Court of Appeals for the Second Circuit was entered on February 15, 1952. By Order of Robert H. Jackson, Associate Justice of this Court, dated May 12, 1952, the time for filing this petition was extended to May 29, 1952.

Statement of Matter Involved

The essential facts were stipulated in the proceeding before the Tax Court of the United States (R. 4, 5, 6, 7). The proceedings were consolidated for trial before the Tax Court and for review by the Court of Appeals.

The matter is summarized in the opinion of the Court of Appeals as follows:

"At the times pertinent here, George W. Hartfield and Edwin E. Healy were officers of the Hartfield-Healy Supply Company, Inc., a New York corporation, and each was the owner of twenty-five of the fifty-two outstanding shares of stock. In 1945 the corporation was insolvent. During that year there was paid by the corporation as salary to each of the above named officers the sum of \$30,000. Such payments were reported on the corporate tax return for that year, and were reported as income received by the recipients in their 1945 individual income tax returns, which were made on a cash basis.

"Upon later examination of the corporate return, the Commissioner found that \$10,000 of the amount paid to each taxpayer as salary, and about \$1000 in life insurance premiums paid for him were excessive, and same were disallowed as deductions therein. Other determinations affecting the corporate returns in prior years were made, resulting in tax deficiencies. In 1947 and 1948 Hartfield

and Healy each paid to the Collector direct, or through the corporation, a total of about \$7,000 to satisfy the balance of the deficiencies due from the corporation. The determinations of the Commissioner above referred to, the insolvency of the corporation, and the liability of respondents as transferees in the amounts paid are not disputed."

The Tax Court of the United States determined that the facts were almost identical with the facts in *Hall C. Smith*, 11 T. C. 174 and that the *Smith* case governed the present proceedings. The basis of the Tax Court's determination in the *Smith* case was that the excessive compensation received by Smith was impressed with a trust from the time of receipt and therefore subject to a legal restriction on its use. Petition for review to the United States Court of Appeals for the Second Circuit was filed by the respondent. The Court of Appeals reversed the Tax Court of the United States, deciding that the excessive compensation was received under a claim of right and without restriction as to its disposition.

The petitioners contended before the Court of Appeals that the excessive compensation was not taxable under the trust fund doctrine, also that Section 15 of the Stock Corporation Law of New York makes void the payment of excessive compensation by an insolvent corporation. The Court of Appeals decided that said Section 15 was not applicable.

Questions Presented

Did that portion of compensation received by the petitioners from an insolvent corporation in 1945 and used by them in 1947 and 1948 to satisfy tax deficiencies of the insolvent corporation constitute income to them in the year of receipt where in a later year, it was agreed that the compensation was excessive and accordingly was disallowed as a deduction to the corporation?

Does Section 15 of the Stock Corporation Law of New York render receipt of excessive compensation paid by an insolvent corporation to its officers non-taxable to the recipient?

Reasons for Allowance of the Writ of Certiorari

The United States Court of Appeals for the Second Circuit, in the present cases, has rendered a decision in direct conflict with the decision of the United States Court of Appeals in *Commissioner of Internal Revenue v. Hall C. Smith*, 6 Cir. 194 F. 2d 536. Motion for rehearing denied. This decision affirmed the Tax Court of the United States in *Hall C. Smith*, 11 T.C. 174, relying on *Commissioner v. Wilcox*, 327 U. S. 404. The Tax Court, in the present cases, stated

“The facts herein are almost identical with those in *Hall C. Smith*, 11 T. C. 174, and we believe that case governs the instant proceedings.”

The denial for rehearing by the Court of Appeals for the Sixth Circuit was made after the decision by the Court of Appeals for the Second Circuit and although respondent's papers on the motion for rehearing are not available it must be assumed that the decision of the Second Circuit was brought to the attention of the Court of Appeals for the Sixth Circuit.

In the present state of the decisions in the two Circuits it is clear that a different answer will be reached by each Circuit on the same set of facts.

There is a question of federal law which would seem to be important enough to warrant examination by this Court. There still is uncertainty about the application of the claim of right doctrine enunciated in *North American Oil v. Burnet*, 286 U. S. 417. A determination by this Court in the present cases would remove much of the uncertainty and

settle a conflict between the Second and Sixth Circuits of the Court of Appeals.

WHEREFORE it is respectfully requested that this petition for writ of certiorari to review the judgment of the Court of Appeals for the Second Circuit should be granted.

EDWIN E. HEALY,
GORDON W. HARTFIELD,
By FRANK J. MAGUIRE,
Attorney for Petitioners.

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Supreme Court of the United States

OCTOBER TERM, 1952

No. 76

EDWIN E. HEALY and GORDON W. HARTFIELD,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' BRIEF

Petition for Certiorari Filed May 20, 1952
Certiorari Granted October 13, 1952

JAMES H. HEFFERN,
1300 Genesee Building,
Buffalo, New York,
Counsel for Petitioners.

BRIEF IN SUPPORT OF THE PETITION

Opinions Below

The opinion of the Tax Court of the United States in this proceeding was promulgated on January 26, 1951. It is reported at 16 T. C. 200, and is printed on pages 9, 10, 11, 12 and 13 of the Record.

The opinion of the United States Court of Appeals for the Second Circuit is reported at 194 F. 2d 662 and is printed on pages 15, 16, and 17 of the Record.

Jurisdiction

The grounds on which jurisdiction of this Court is invoked are set forth in the Petition at pages 4 and 5 thereof.

Statement of the Case

The Statement of the Case appears in the Petition at pages 2 and 3 and is not repeated here.

Specification of Errors

The Court of Appeals for the Second Circuit erred:

In holding that petitioners received the excessive compensation under a claim of right and without restrictions as to its disposition.

In holding that Section 15 of the Stock Corporation Law of New York was not applicable to the present facts.

Statutes Involved

The pertinent provisions of the Internal Revenue Code and of the Treasury Department Regulations and Section 15 of the Stock Corporation Law of New York are printed at the end of this Brief.

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Argument

THE AMOUNTS OF EXCESSIVE COMPENSATION RECEIVED BY PETITIONERS AND USED TO SATISFY THE TAX LIABILITY OF HARTFIELD-HEALY SUPPLY CO., INC. WERE NOT RECEIVED UNDER A CLAIM OF RIGHT AND WITHOUT RESTRICTIONS AS TO THEIR USE.

The Tax Court of the United States determined that the petitioners received the excessive compensation impressed with a trust from the time of their receipt. The Court of Appeals in reversing the Tax Court stated at page 663:

"There would seem to be no question here that the respondents received their 1945 salaries from the corporation under a claim of right, and without restrictions as to their disposition, which is the test outlined in the North American Oil case. The fact that such salaries were reported on the individual tax returns as earnings or income would seem to be determinative of that question."

This holding, applied to the facts in *Commissioner v. Smith*, 6 Cir., 194 F. 2d 536 would have produced the exact opposite of the actual result in that case. The Tax Court in the present cases relied almost entirely on its decision in *Smith v. Commissioner*, 11 T. C. 64. The Sixth Circuit affirmed the Tax Court and the Second Circuit reversed the Tax Court, resulting in a direct conflict.

It is submitted that the Second Circuit has oversimplified the claim of right doctrine. Under its reasoning the embezzler in *Commissioner v. Wilcox*, 327 U. S. 404, 90 L. Ed. 752, 66 S. Ct. 546 would have been taxed on the embezzled money had he reported it on his income tax return. It seems to the petitioners that claim of right necessarily presupposes at least some semblance of beneficial title. It does not seem that claim of right can be based solely on the claimant's intent or state of mind.

The United States Court of Appeals for the Sixth Circuit in *Commissioner v. Smith, supra*, said

"And it appearing that the receipt of the excessive salary to the extent of which the respondent was held liable as transferee constituted 'the bare receipt of property or money wholly belonging to another,' *Commissioner of Internal Revenue v. Wilcox*, 327 U. S. 404, 66 S. Ct. 546, 549, 90 L. Ed. 752 and that the respondent held the funds not for himself but for the creditors of the transferor;"

The fact that petitioners reported the excessive compensation indicates that they claim the compensation as their own but the claim of right doctrine has two sides, one the claim and the other freedom from restrictions as to use. At the time the compensation was paid by Hartfield-Healy Supply Co., Inc. it was insolvent and its Balance Sheet showed Accrued Federal Income Taxes of \$7,888.35 (R. 6). At least to that extent there was a restriction as to the use of the excessive compensation.

Petitioners believe, and feel that both the Second Circuit and the respondent would agree with their belief, that the real question in these cases is whether or not there was any transferee liability existing on December 31, 1945. Or in other words was the existence of excessive compensation a fact on December 31, 1945. Bearing in mind that the determination of the respondent was not contested, petitioners fail to perceive how or why the determination was a "later fact" as the Second Circuit held. The excessive compensation was a fact when paid, its discovery may have come in a later year, but it existed as a fact when payment was made. The respondent, in the present cases, merely ascertained a fact already in existence. His uncontested determination is not a later fact which changed the nature of the original payment.

Therefore, if payment of excessive compensation was a

fact in 1945, and petitioners submit it could not have been otherwise, a transferee liability existed in 1945 and the compensation in question was under a definite restriction, at least to the extent of the tax liability existing at December 31, 1945.

SECTION 15 OF THE STOCK CORPORATION LAW AFFECTS THE FEDERAL TAXATION OF INCOME SINCE IT RENDERS VOID CERTAIN PROHIBITED TRANSACTIONS.

The Court of Appeals for the Second Circuit in its opinion at page 663 states:

"Section 15 of the Stock Corporation Law of the State of New York is not applicable here. If it has any bearing on a question of federal taxation, we are not persuaded that it would override the legal principle above referred to. In any event it would apply only in case of payments made with the intent of giving a preference to creditors. Such intent must exist or be established to invoke the statute and to establish a liability upon the recipient. The contention lacks a factual basis. *New York Credit Men's Association v. Hasenberg*, D. C., 26 F. Supp. 877; affirmed 2 Cir., 107 F. 2d 1026, per curiam."

Petitioners believe that the cited case is authority only for the principle that an officer or director who is *not a transferee* must have an intent to create a preference. Common sense should dictate that an officer of an insolvent corporation who transfers property to himself must be held to have received it in trust, *regardless of his intent*. In any event the officer, transferee in the cited case, was one of the defendants against whom a judgment was rendered, in the full amount of the transferred property.

Section 15 of the Stock Corporation Law of New York is printed at page 12 of this Brief. That section provides that a transfer in violation of it "shall be void". The

section is an extension of the trust fund doctrine, creating a statutory prohibition against the payment of excessive compensation to an officer by an insolvent corporation. Therefore the petitioners contend that the New York statute can and does have an effect on the federal taxation of income. The petitioners here, as in *Commissioner v. Wilcox, supra*, were at all times under an unqualified duty and obligation to repay the excessive compensation. The very transfer was void, *not* a mistake as in *U. S. v. Lewis*, 340 U. S. 590, and *not* subject to litigation as in *North American Oil v. Burnet*, 286 U. S. 417.

Finally, the petitioners point out that these are specific cases of *admittedly* excessive compensation paid by an *insolvent* corporation where the compensation went to satisfy a transferee liability.

Conclusion

The decision below is incorrect and in conflict with the decision of the Sixth Circuit in *Commissioner v. Smith*, 194 F. 2d 536. The question is of sufficient importance that the petition for writ of certiorari should be granted.

Respectfully submitted,

FRANK J. MAGUIRE,
Attorney for Petitioners.

APPENDIX

STATUTES INVOLVED

Internal Revenue Code:

Sec. 22. Gross Income.

(a) General Definition. "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, . . . also from . . . dividends . . .

(26 U. S. C. 1946 ed., Sec. 22)

Sec. 42 (As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687). Period in which items of gross income included.

(a) General Rule. The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period. . . .

(26 U. S. C. 1946 ed., Sec. 42)

Sec. 311. Transferred Assets.

(a) Method of Collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) Transferees. The liability, at law or in equity, of a transferee of property of a taxpayer in respect of the tax (including interest, additional amounts, and additions to the

tax provided by law) imposed upon the taxpayer by this chapter.

(26-U. S. C. 1946 ed., Sec. 311)

Section 15. New York Stock-Corporation Law.

§15. Prohibited transfers to officers, stockholders, directors or creditors. No corporation which shall have refused to pay any of its notes or other obligations, when due, in lawful money of the United States, nor any of its officers or directors, shall transfer any of its property to any of its officers, directors or stockholders, directly or indirectly for the payment of any debt, or upon any other consideration than the full value of the property paid in cash. No conveyance, assignment or transfer of any property of any such corporation by it or by any officer, director or stockholder thereof, nor any payment made, judgment suffered, lien created or security given by it or by any officer, director or stockholder when the corporation is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over other creditors of the corporation, shall be valid, except as to any rights or interests which may be acquired thereunder by any person without notice or reasonable cause to believe that such conveyance, assignment, transfer, payment, judgment, lien or security would effect a preference, and except also that laborers' wages for services shall be preferred claims and be entitled to payment before any other creditors out of the corporation assets in excess of valid prior liens or incumbrances. No corporation formed under or subject to the banking, insurance or railroad law shall make any assignment in contemplation of insolvency. Every person receiving by means of any such prohibited act or deed any property of a corporation shall be bound to account therefor to its creditors or stockholders or other trustees. No stockholder of any corporation shall make any transfer or assignment of his stock therein to any person in contemplation of its insolvency. Every transfer or assignment or other act done in violation of the foregoing provisions of this section shall be void, except as hereinbefore provided.

Every director or officer of a corporation who shall be concerned in the making of any conveyance, assignment, transfer or payment, the suffering of any judgment or the creation of any lien or the giving of any security by such corporation when it is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over any of the other creditors of the corporation or who shall violate or be concerned in violating any other provision of this section, shall be personally liable to the creditors and stockholders of the corporation of which he shall be director or an officer to the full extent of any loss they may respectively sustain by such violation.

(1851)

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Supreme Court of the United States

OCTOBER TERM, 1952

No. 76

EDWIN E. HEALY, and GORDON W. HARTFIELD,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONERS

Opinions Below

The opinion of the Tax Court of the United States is reported in 16 T. C. 200 and the opinion of the United States Court of Appeals is reported at 194 F. 2d 662.

Jurisdiction

Jurisdiction is invoked under U. S. C. Title 28, section 1254 (1) and section 1141 (a) of the Internal Revenue Code.

An order allowing a writ of certiorari to the United States Court of Appeals for the Second Circuit was filed on October 13, 1952.

Statement

The essential facts were stipulated in the proceeding before the Tax Court of the United States (R. 3, 4, 5, 6, 7). The proceedings were consolidated for trial before the Tax Court and for Review by the Court of Appeals.

Petitioners, both on a cash receipts and disbursements basis, filed their 1945 income tax returns and paid the tax shown to be due thereon on or about March 27, 1946, with the Collector of Internal Revenue for the 28th district of New York (R. 4).

At all times pertinent hereto, petitioner Healy was president and petitioner Hartfield was vice-president and treasurer of Hartfield-Healy Supply Co., Inc. a New York corporation (hereinafter called the corporation) and each petitioner owned 25 of the total of 52 shares of the corporation's common stock (R. 4).

During the year 1945, the corporation made cash salary payments of \$8,081.40 to Healy and \$8,136.30 to Hartfield. In December 1945, it accrued \$21,918.60 as additional salary payable to Healy and \$21,863.70 to Hartfield and charged against each of those accounts the amount of \$5,042.70 which represented the amount of withholding tax paid by it in connection with each salary. On March 30, 1946, cash payments representing the balance of the 1945 accrued salaries were made to Healy and Hartfield in the respective amounts of \$16,875.90 and \$16,821.00. Each included in his individual income tax return for 1945 an amount of \$30,000.00 as salary. During the year 1945, the corporation paid insurance premiums on the lives of Healy and Hartfield in the amounts of \$1,131.25 and \$1,044.20, respectively, which premiums were for petitioners' benefit (R. 4, 5).

The Commissioner, upon examination of the corporation's return for 1945, disallowed as deductions \$10,000.00

of each petitioner's salary and the life insurance premiums paid for petitioners as excessive compensation (R. 5).

Similar disallowances were made for salaries paid in the years 1941, 1942 and 1943. The amounts are set out below (R. 4):

<i>Year</i>	<i>Amounts Paid</i>	<i>Amounts Disallowed</i>
1941	\$28,000.	\$ 8,000.
1942	62,000.	22,000.
1943	62,000.	2,000.

In addition the Commissioner disallowed as excessive compensation in 1943, the payment of life insurance premiums by the corporation for the benefit of the petitioners in the total amount of \$2,175.45. The following deficiencies in tax and interest resulted from those disallowances (R. 4):

<i>Year</i>	<i>Income Tax</i>	<i>Excess Profits Tax</i>	<i>Interest</i>
1941	\$1,523.64	\$ 1,882.37	\$ 476.14
1942	420.02	20,360.01	3,100.06
1943	221.07	-0-	11.63

The 1945 income tax return of the corporation showed a net loss of \$45,232.75. Because of the disallowance of excessive compensation and several other minor adjustments, the corporation's net loss for 1945 was reduced to \$21,741.29. The application of the net loss carry-back based upon that adjusted net loss resulted in the elimination of the 1942 and 1943 income tax deficiencies and the interest thereon and reduced the 1942 excess profits tax deficiency by the amount of \$13,834.70 and the interest due thereon by the amount of \$1,489.80. There remained unpaid by the corporation the following deficiencies in tax and interest (R. 5):

Year	Income Tax	Excess Profits Tax	Interest
1941	\$1,523.64	\$1,882.37	\$ -0-
1942	-0-	6,525.31	1,465.33

On December 31, 1947, each petitioner advanced \$5,250.00 to the corporation to be used to pay the remaining income and excess profits tax deficiencies, and on that same day, the corporation paid \$9,931.32 out of those funds to the Collector of Internal Revenue at Buffalo, New York, in partial satisfaction of those deficiencies (R. 5).

On December 24, 1948, each petitioner paid \$715.37 to the Collector of Internal Revenue at Buffalo in satisfaction of the balance due from the corporation on the deficiencies (R. 6).

At December 31, 1945, the balance sheet of the corporation showed total assets of \$72,201.46 against liabilities of \$98,709.66 (R. 6).

Neither the disallowance of compensation or the existence of transferee liability was contested by either petitioner.

The Tax Court of the United States determined that the amounts of excessive compensation used in satisfaction of petitioners' transferee liabilities were impressed with a trust from the time of receipt, therefore subject to a restriction on their use and not taxable income to the petitioners. The Court of Appeals for the Second Circuit reversed the Tax Court, deciding that the excessive compensation was received under a claim of right and without restriction as to its disposition (R. 13, 16, 17).

These cases come before this Court on an order granting a writ of certiorari to the United States Court of Appeals for the Second Circuit filed October 13, 1952 (R. 21).

Specification of Errors

The Court of Appeals for the Second Circuit erred in holding that amounts received by the petitioners as excessive compensation in the taxable year 1945, which the petitioners later refunded to the corporation in order to satisfy its tax liabilities, were received under a claim of right and without restrictions as to their disposition and were includible in their incomes for the taxable year 1945.

Summary of Argument

To the extent used by petitioners to satisfy their liabilities as transferees, the amounts of excessive compensation received by them from an insolvent corporation did not constitute taxable income to them. Such receipts were received in trust for creditors and the petitioners did not receive them under a claim of right without restriction as to their use. They did not have such control over the compensation that, as a practical matter, they could be said to have derived readily realizable economic value from it.

Under the principle of the annual accounting system, the fact and amount of excessive compensation was knowable as was the transferee liability and the amount thereof of the petitioners, at the end of the taxable year 1945 because neither the disallowance of compensation or the existence of transferee liability was contested.

ARGUMENT

The amounts of excessive compensation received by petitioners and used to satisfy the tax liability of Hartfield-Healy Supply Co., Inc. were not received under a claim of right and without restrictions as to their use.

The issue presented in this appeal is whether each of the petitioners is entitled to exclude from his taxable income from the year 1945, \$5,681.03 of the total salary of \$30,000.00 from Hartfield-Healy Supply Co., Inc., reported by each for that year. In auditing the income of that corporation for 1945, the Commissioner of Internal Revenue disallowed as a deduction, excessive salaries paid to each of the petitioners in the amounts of \$10,000.00. This adjustment reduced the corporation's operating loss for 1945, as originally reported, so that the resulting carryback loss was not sufficient to eliminate 1941 and 1942 federal tax deficiencies. The corporation did not dispute this disallowance.

Thereafter, on December 31, 1947, each petitioner paid \$5,250.00 to the corporation to be used by it to pay its 1941 and 1942 deficiencies and on the same day the corporation paid \$9,931.32 out of those funds in partial satisfaction of those deficiencies. On December 31, 1948, each taxpayer paid \$715.37 in satisfaction of the balance due from the corporation on its 1941 and 1942 deficiencies. The petitioners admitted their liability as transferees.

The corporation was insolvent in 1945. Both the Tax Court and the Court of Appeals are agreed on this (R. 11 and 15).

The Tax Court determined that the amounts of excessive compensation ultimately paid in satisfaction of their trans-

feree liabilities were not income to the petitioners because they were impressed with a trust from the time of their receipt (R. 13). The Court of Appeals in reversing the Tax Court held the petitioners received their 1945 salaries from the corporation under a claim of right, and without restriction as to their disposition, thus coming within the test outlined in *North American Oil Consolidated v. Burnet*, 286 U. S. 417, saying that:

"* * * The fact that such salaries were reported on the individual tax returns as earnings or income would seem to be determinative of that question" (R. 17).

Obviously, the Court of Appeals has oversimplified the claim of right doctrine. The fact that a taxpayer reports income, the petitioners admit, shows that he claims the income but the claim of right doctrine enunciated in *North American Oil Consolidated* has two sides, one the claim and the other freedom from restrictions as to use. The reporting of income cannot determine, in fact can have little bearing on, the question of freedom from restrictions as to use. The answer to that question is not in the taxpayer's mind, it is in the circumstances under which he received the income. If restrictions are imposed, either by law or by agreement between the parties, the *North American Oil Consolidated* test is not met and the income is not taxable to the claimant.

The petitioners' position and that of the Tax Court is that by reason of the trust fund doctrine a restriction as to disposition existed from the very moment of receipt. The position of the Court of Appeals apparently is that a restriction did not come into existence until after the end of the taxable year.

Because the claim of right rule is a corollary of the annual accounting rule it becomes necessary to discuss first

the present facts in the light of the annual accounting principle.

The Court of Appeals in reversing the Tax Court said:

"* * * The liability of the taxpayers as transferees must necessarily have awaited the determination as to the existence and amount of excessive salary payments. It was not fixed in 1945. Even though corporate insolvency were admitted, the liability of the officers did not exist until excessive payments were determined as a fact, and it was established that a deficiency in the corporate tax existed. * * * (R. 17).

This conclusion is a denial of the annual accounting principle laid down in *Burnet v. Sanford & Brooks Co.* (1931) 282 U. S. 359. Essentially, the rule is that income must be computed annually as the net result of all transactions within the year. The practical application of the rule probably is expressed best in *Dixie Pine Products Co. v. Commissioner*, (1944) 320 U. S. 516 in these words:

"* * * It has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer * * *"

See also *United States v. Anderson*, 269 U. S. 422, 440.

Reasonable compensation is a deductible item just as business expense, interest and certain taxes are deductible items. All of the events which determine reasonableness occur during the taxable year. Events occurring before or after the taxable year can have no effect on the question of whether compensation is reasonable. Excessive com-

compensation is a fact when paid, its discovery may come in a later year but it exists as a fact when payment is made. The respondent, in the present cases merely ascertained a fact already in existence. His uncontested disallowance is not a later fact which changed the nature of the original payment. If it were otherwise, then under *Dixie Pine Products Co. v. Commissioner, supra*, the income of the corporation for the year 1945 could not have been changed.

The only compensation properly accruable by the corporation in this case was reasonable compensation, hence the corporation's operating loss was overstated and the increased deficiencies were items properly accruable in 1945. The disallowance of compensation was not contested, consequently proper accounting required the accrual of the resulting increased deficiencies in 1945. Therefore at December 31, 1945, a deficiency in corporate taxes existed under the annual accounting principle. And since the disallowance was not contested, at December 31, 1945, the corporation being insolvent, by payment of such excessive salaries, made the petitioners its transferees. Because they did not contest that liability they became liable as transferees in 1945.⁽¹⁾

In short, the petitioners cannot accept, and they ask the Court to reject, the respondent's one-sided view of the annual accounting principle. If it is perfectly proper to open a tax year for the corporation in order to reflect what the Court of Appeals refers to as "subsequent facts" (R. 16), it seems equally proper to open it for the individuals.

⁽¹⁾ The fact that the corporation did not contest the disallowance of salaries and the petitioners did not contest their transferee liability distinguishes the present cases from *United States v. Lewis*, 340 U. S. 590. It also distinguishes them from *Commissioner v. Smith*, 6 Cir., 194 F. 2d 563. See: *F. A. Gillespie & Sons Co.* (Tax Court Memo) 3 T. C. M. 1073, 1078. Disagreement with a State Tax Commission over correct amount of additional tax does not prevent accrual.

Because the petitioners in 1945 were under a transferee liability and because the transferor was insolvent the trust fund doctrine is applicable. Petitioners are aware that the term, trust fund doctrine, has been used loosely in numerous decisions; that the doctrine has been erroneously applied in some cases and even rejected in some jurisdictions. But in New York State the doctrine has been adopted by the courts and extended by statute. The pioneer case is *Bartlett v. Drew*, 57 N. Y. 587, where the New York Court of Appeals said at page 589:

“* * * It is a very plain proposition that the stock and property of every corporation is to be regarded as a trust fund for the payment of its debts, and its creditors have a lien and the right to priority of payment over any stockholder. (2 Story Eq. Jur. §1252)”

Later the same Court cited *Bartlett v. Drew* in *Cole v. Millerton Iron Company*, 133 N. Y. 164 and at page 168 said:

“* * * The assets of a corporation are a trust fund for the payment of its debts upon which the creditors have an equitable lien both as against the stockholders and all transferees, except those purchasing in good faith
* * * ”

The only question that has arisen in the New York Courts concerning the doctrine is whether it applies before insolvency, there being no disagreement as to its application once insolvency exists. Furthermore the Federal Courts recognize that New York State follows the trust fund doctrine. See *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, (C. C. A. 2nd) 109 F. 2d 924, 928 where the Circuit Court, in discussing the trust fund rule in New York, generally, and the case of *Reif v. Equitable Life Assurance Society*, 268 N. Y. 269, said:

“* * * The court recognized the force of the trust fund rule, which had been invoked by the trial court, but declared it inapplicable to facts of the Reif case
* * * ”

See also *In re Crescent Box Mfg. Corporation*, 46 F. Supp. 140, 141 where the Court decided that the following conclusion of a bankruptcy referee was sound:

"The referee concluded that the property of an insolvent corporation constitutes a trust fund for the benefit of its creditors, and that no stockholder, director or officer could acquire any of the corporation's assets during such insolvency except as trustee for its creditors; § 15. New York Stock Corporation Law; *Ward v. City Trust Co. of New York* 192 N. Y. 61, 84 N. E. 585; *Caesar v. Bernard*, 156 App. Div. 724, 141 N. Y. S. 659 * * *"

To make even more certain that corporate creditors enjoyed full protection in the event of insolvency New York enacted Section 15 of the New York Stock Corporation Law (Appendix, *infra*). That section prohibits certain transfers by an insolvent corporation and, in the words of the section, a transfer in violation of the section "shall be void". Excessive compensation is a prohibited transfer under the section. See *Marine Trust Co. v. Tralles*, 147, Misc. 426, 263 N. Y. Supp. 750; distinguishing *Feigenbaum v. Narragansett Stables Co.*, 127 Misc. 114, 215 N. Y. Supp. 328, aff'd 219 A. D. 729, aff'd 245 N. Y. 628; *Commissioner v. Renyx* (Second Cir.) 66 F. 2d 260.

Thus in New York, in addition to the trust fund doctrine, there is a statutory prohibition against the payment of excessive compensation by an insolvent corporation and in the very words of the statute the payment "shall be void". The words void and voidable frequently are used incorrectly but when a statute contains the word "void" we must presume that the word void and not voidable is meant. And it seems clear that the purpose of Section 15 of the Stock Corporation Law was to prevent the vesting of any beneficial title in a transferee under a prohibited transfer.

As to the application of local law in this type of case *Mertins Law of Federal Income Taxation*, Vol. 9 § 53.06 states:

"General Nature of Transferee Liability. The transferee provisions do not impose any new obligations upon the transferee of property of a taxpayer; they merely permit collection from him by a summary procedure of his existing liability in law or in equity. In other words, it is the liability of the transferee that could have been enforced by appropriate remedy in the federal courts which is enforced under the transferee provisions. Thus, the nature and extent of a transferee's liability must be determined by the settled principles of the common law and federal and local statutes." * * * (Emphasis supplied)

It should be noted that in the *Barr & Creelman, supra*, case and in *Crescent Box Manufacturing Corporation, supra*, recourse was had to local law although a federal law, the Bankruptcy Act, was involved. See also *Harwood v. Eaton*, 68 F. 2d 12 (C. C. A. 2d), cert. den. 292 U. S. 636.

So it seems fair to conclude that in order to determine what interests or rights have been created, reference to local law is necessary and then, in order to determine what interests or rights should be taxed, reference must be had to the federal law. In the present cases the interest or right created is the primary question because if the petitioner's rights in the excessive compensation are only those of trustees they may not be taxed as beneficial owners. Petitioners present this argument relative to local law because they believe that it is necessary to show that the trust fund doctrine is an accepted principle in New York State. If the trust fund doctrine had been rejected in New York there is serious doubt in the petitioners' minds that the doctrine would be available for federal tax purposes to a New York resident.

But the doctrine has been adopted and extended through Section 15 of the Stock Corporation Law and is available to petitioners for the purpose of determining their interest in the excessive compensation. Their interest, even to those most critical of the doctrine, can only be that of trustees in the specific case of payment by an insolvent corporation, insolvent at the time of payment, of excessive compensation to its controlling stockholders. That is the specific case here and must not be obscured or confused by a profusion of references to dissimilar facts and decisions.

For example, in respondent's memorandum on petition for certiorari, *Fleischer v. Commissioner*, 158 F. 2d 42 (C.A. 8th) is stated to involve the precise question here presented, and the Court of Appeals directs attention to the case (R. 16). The cited case did *not* involve the question which we ask this Court to answer. In the *Fleischer* case, the transferor corporation *was not insolvent before or after* the salary payment. Its capital was impaired but its assets exceeded its liabilities to creditors before and after the payments. Incidentally, the *Fleischer* case was decided under the *Dobson* rule. As to the reference of the Court of Appeals to *Pittman v. Commissioner*, 14 T. C. 449, petitioners can only point out that respondent specifically called the attention of Judge Black to that case before the decision of the Tax Court in the present cases was rendered. Finally *United States v. Lewis, supra*, must be distinguished on three grounds, the money received was not subject to the trust fund doctrine, the question of ownership of the funds was a private controversy, as in *National City Bank v. Helvering*, (C.A. 2d) 98 F. 2d 93, 96, and *Rutkin v. United States*, 343 U. S. 130, and finally, as pointed out before, the present petitioners never contested their liability to the Treasury.

In view of the foregoing it seems clear that the petitioners, at the end of 1945, were under an existing liability for federal income taxes of an insolvent corporation and that under the trust fund doctrine and the New York State statutes, they received the excessive compensation paid to them, in trust for creditors. Consequently, the amounts thereof used to satisfy the corporation's tax liability must be excluded from their taxable incomes for 1945.

Petitioners, as a practical matter, did not receive readily realizable economic value, in 1945, from the compensation received by them to the extent of the amounts paid in satisfaction of their transferee liabilities.

The Stipulation of Facts shows that both petitioners were on a cash receipts basis (R. 4), that Hartfield-Healy Supply Co., Inc. made cash salary payments of \$8,081.40 to petitioner Healy and \$8,136.20 to petitioner Hartfield during the year 1945, that in December, 1945, the corporation accrued \$21,918.60 as additional salary payable to Healy and \$21,863.70 as additional salary payable to Hartfield and charged against each of these accrued amounts the amount of \$5,042.70 which represented the amount of withholding tax paid by it in connection with each salary (R. 4, 5). On March 30, 1946, cash payments representing the balance of the 1945 accrued salaries were made to Healy and Hartfield in the respective amounts of \$16,875.90 and \$16,821.00 (R. 5). The corporation had a surplus deficit at December 31, 1945, of \$31,708.20 (R. 6) and was found to be insolvent by both the Tax Court of the United States and the United States Court of Appeals for the Second Circuit (R. 11 and 15). Neither petitioner owned more than 50% of the stock of Hartfield-Healy Supply Co., Inc. (R. 4).

On the basis of the above factual situation it is obvious that the realizable economic value in 1945 of what petition-

ers received could not have exceeded the total of cash payments, withholding taxes paid for them and the fair market value of the notes received by them.

The petitioners concede that it must be assumed that they received notes for \$16,875.90 and \$16,821.00 respectively and that these notes were treated as payment and not merely evidence of debts: See *Schlemmer v. U. S.*, 94 F. (2d) 77 (C.A. 2nd 1938) (notes as evidence of a debt are not income to recipient in year of receipt). They further concede that the question of fair market value of such notes must be based solely on the existing record. It is respectfully submitted however, that on the basis of that record, these notes could not have had a fair market value in excess of \$3,602.34 and \$3,586.36 respectively, or a total of \$7,188.70. Assuming that notes were given to the petitioners in the total sum of \$33,696.90, the liabilities owed on December 31, 1945 to persons other than the petitioners would be:

Accounts Payable.....	\$11,837.83
Notes Payable.....	33,000.00
Accrued Expenses.....	12,286.58
Accrued Federal Income Taxes....	7,888.35
Total Liabilities.....	<u>\$65,012.76</u>

To apply against these liabilities the corporation had total assets of \$72,201.46 (R. 6). If all the assets of the corporation could be converted into cash (which is highly unlikely considering Accounts Receivable were \$11,837.83 and Inventories were \$37,682.03) there would be only \$7,188.70 to apply against petitioners' notes. Under these circumstances it is completely unrealistic to conclude that, conceding receipt of notes by the petitioners in 1945, they as a practical matter derived readily realizable economic value in the amount of the face value of the notes, \$33,696.90.

The petitioners wish to make clear to the Court that in making this argument they are not attempting to raise a new issue or advance a new theory. They seek only to demonstrate to the Court that the Tax Court of the United States in *Hartfield v. Commissioner*, 16 T.C. 200 ^{reached} ~~received~~ the correct conclusion, namely that the portions of the excessive incomes which were ultimately paid in satisfaction of petitioners transferee liabilities were not includible in their income for the year 1945.

Conclusion

The decisions of the United States Court of Appeals for the Second Circuit should be reversed and the decision of the Tax Court of the United States should be affirmed.

November, 1952.

Respectfully submitted,

James H. Heffern
 JAMES H. HEFFERN,
 Counsel for Petitioners.

APPENDIX

STATUTES INVOLVED

Internal Revenue Code:

Sec. 22. Gross Income.

(a) General Definition. "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, . . . also from . . . dividends. . . .

(26 U. S. C. 1946 ed., Sec. 22)

Sec. 42 (As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687). Period in which items of gross income included.

(a) General Rule. The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period. . . .

(26 U. S. C. 1946 ed., Sec. 42)

Sec. 311. Transferred Assets.

(a) Method of Collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) Transferees. The liability, at law or in equity, of a transferee of property of a taxpayer in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

(26 U. S. C. 1946 ed., Sec. 311)

Section 15. New York Stock Corporation Law.

§15. Prohibited transfers to officers, stockholders, directors or creditors. No corporation which shall have refused to pay any of its notes or other obligations, when due, in lawful money of the United States, nor any of its officers or directors, shall transfer any of its property to any of its officers, directors or stockholders, directly or indirectly for the payment of any debt, or upon any other consideration than the full value of the property paid in cash. No conveyance, assignment or transfer of any property of any such corporation by it or by any officer, director or stockholder thereof, nor any payment made, judgment suffered, lien created or security given by it or by any officer, director or stockholder when the corporation is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over other creditors of the corporation, shall be valid, except as to any rights or interests which may be acquired thereunder by any person without notice or reasonable cause to believe that such conveyance, assignment, transfer, payment, judgment, lien or security would effect a preference, and except also that laborers' wages for services shall be preferred claims and be entitled to payment before any other creditors out of the corporation assets in excess of valid prior liens or incumbrances. No corporation formed under or subject to the banking, insurance or railroad law shall make any assignment in contemplation of insolvency. Every person receiving by means of any such prohibited act or deed any property of a corporation shall be bound to account therefor to its creditors or stockholders or other trustees. No stockholder of any corporation shall make any transfer or assignment of his stock therein to any person in contemplation of its insolvency. Every transfer or assignment or other act done in violation of the foregoing provisions of this section shall be void, except as hereinbefore provided. Every director or officer of a corporation who shall be concerned in the making of any conveyance, assignment, transfer or payment, the suffering of any judgment or the creation of any lien or the giving of any security by such corporation when it is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over any of the other creditors of the corpo-

ration or who shall violate or be concerned in violating any other provision of this section shall be personally liable to the creditors and stockholders of the corporation of which he shall be director or an officer to the full extent of any loss they may respectively sustain by such violation.

(1851)

NO. 78

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In the Supreme Court of the United States

OCTOBER TERM, 1952

EDWIN E. HEALY and GORDON W. HARTFIELD,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court
of Appeals for the Second Circuit

MEMORANDUM FOR THE RESPONDENT

In the Supreme Court of the United States

OCTOBER TERM, 1952

No. 76

EDWIN E. HEALY and GORDON W. HARTFIELD,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court
of Appeals for the Second Circuit

MEMORANDUM FOR THE RESPONDENT

The question presented in this case was settled by this Court in *United States v. Lewis*, 340 U.S. 590, with which the decision below is in complete accord. Reaffirming the principles laid down in *North American Oil v. Burnet*, 286 U.S. 417, this Court in *Lewis* held (pp. 591-592) that under our "annual" system of tax accounting a taxpayer who reports compensation received under a "claim of

right" and without restriction as to its use, and in a later year is required to restore a part of it because of the invalidity of his claim, may not reopen his return and recalculate his tax for the earlier year but may deduct the amount repaid as a loss in the year of repayment. Applying this rule, the court below correctly held that taxpayers, who had received compensation in 1945 and reported the amounts received as income in their tax returns for that year, could not reopen the returns in order retroactively to expunge from the reported compensation of that year portions which they subsequently (1947 and 1948) relinquished in satisfaction of transferee liability. The decision below is also in accord with *Fleischer v. Commissioner*, 158 F. 2d 42 (C.A. 8th), which involved the precise question here presented. It is in conflict, however, with *Commissioner v. Smith*, 194 F. 2d 536, (C.A. 6th), in which the Government has filed a petition for a writ of certiorari, No. 138, this Term.

The petition for certiorari in the *Smith* case requests summary reversal of the decision below in that case, on the authority of this Court's decisions in *Lewis* and *North American Oil*. On the basis of the same authorities, and for the reasons set forth in our petition in the *Smith* case, we believe that summary affirmance of the decision below or a denial of certiorari is likewise appropriate here. The Tax Court regarded the stipulated facts of this case as "almost identical" with those of *Smith*.

(R. 12);¹ it was of the opinion that its decision in that case "governs" its decision in this one (R. 12); and its decision in this case, as in *Smith*, was rendered prior to *Lewis*. The only difference between the two cases lies in the circumstance that the Court of Appeals for the Sixth Circuit in *Smith*, in reviewing the Tax Court's decision, disregarded or overlooked this Court's intervening decision in *Lewis*, while the Court of Appeals for the Second Circuit in this case correctly followed the principles upheld in *Lewis*. Since this Court's decision in that case has removed these principles from the area of controversy,² it would seem unnecessary to have further briefs and argument in the present cases. In the words of the court below (R. 17), the mere "citation of *North American Oil v. Burnet, supra*,

¹ The Tax Court properly declined (R. 12) to distinguish the cases on the ground that the subsequently accrued transferee liability was admitted by taxpayers here, whereas it was contested by the taxpayer in *Smith*. See *Fleischer v. Commissioner, supra*. The common factor decisive of both cases is that no transferee liability was asserted by the Commissioner or recognized by the taxpayers until a year subsequent to that in which the compensation was received under a claim of right and reported as income.

² The Court declared that the "claim of right" rule is a corollary of the "annual accounting" rule, and is now deeply rooted in the federal tax system; that exceptions to the rule are not permissible merely because the taxpayer is mistaken as to the validity of his claim; and that the rule applies irrespective of whether its application in a particular case results in an advantage or disadvantage to a taxpayer. 340 U.S., at 591-592.

and *U. S. v. Lewis, supra*, would seem to be sufficient to demonstrate that" a taxpayer may not reopen his tax return for a prior year in order to reflect a subsequently accrued transferee liability.³

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

JULY 1952.

³ In contending (Pet. 7-10) that the compensation which they reported in the taxable year was not received under a "claim of right," because their claim to a part of it was invalid, petitioners advance the very argument which this Court unequivocally rejected in *Lewis*. See also *Rutkin v. United States*, 343 U. S. 130. The argument rests (Pet. 7-10) upon *Commissioner v. Wilcox*, 327 U. S. 404, which was distinguished in *Lewis* (340 U. S., at pp. 591-592) and has since been limited to its facts in *Rutkin* (343 U. S., at p. 138).

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No. 76

In the Supreme Court of the United States

OCTOBER TERM, 1952

EDWIN E. HEALY AND GORDON W. HARTFIELD,
PETITIONERS

v.
COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE COMMISSIONER

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ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE COMMISSIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 9-13) are reported at 16 T. C. 200. The opinion of the Court of Appeals (R. 15-17) is reported at 194 F. 2d 662.

JURISDICTION

The judgments of the Court of Appeals were entered on February 15, 1952. (R. 18-19.) The petition for a writ of certiorari was filed on May 20, 1952, within the extended time allowed by order

dated May 12, 1952 (R. 20), and was granted on October 13, 1952 (R. 21). The jurisdiction of this Court rests upon 28 U.S.C., Section 1254.

QUESTION PRESENTED

In 1945 taxpayers each received a salary of \$30,000 from an insolvent corporation owned by them. Each reported the full amount in his individual income tax return for 1945 and the corporation in its 1945 return claimed deductions for both salary payments. The Commissioner in a subsequent year determined that the salaries were in excess of reasonable compensation, and taxpayers, having become subject to transferee liability, each paid a total of \$5,681.03 on tax deficiencies of the corporation for prior years. May taxpayers' individual 1945 tax liabilities be recomputed by excluding such payments from their income for that year?

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes, gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the trans-

action of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*

—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts

are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 42.)

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection.*—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter * * *:

(1) *Transferees.*—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

* * * * *

(26 U.S.C. 1946 ed., Sec. 311.)

STATEMENT

The facts, all of which were stipulated, were found by the Tax Court as stipulated (R. 9) and may be summarized as follows:

Taxpayer Edwin E. Healy was president of the Hartfield-Healy Supply Company, Inc., a New York corporation, and taxpayer Gordon W. Hartfield was vice-president and treasurer of the corporation. Each owned 25 of the total of 52 shares of the corporation's common stock (R. 4, 10).

In 1945, when the corporation was insolvent,¹ Healy and Hartfield each received a salary of \$30,000 from the corporation. Each was on the cash receipts and disbursements basis and each in his 1945 income tax return included his \$30,000 salary in his individual income. They filed their 1945 returns and paid the tax shown to be due thereon on or about March 27, 1946. (R. 4, 9-10.) During 1945 the corporation also paid insurance premiums on the lives of Healy and Hartfield in the amounts of \$1,131.25 and \$1,044.20, respectively.² (R. 5, 10.)

Upon examination of the corporation's 1945 return, the Commissioner determined that \$10,000 of the salary paid to each taxpayer and the life insurance premiums paid for taxpayers constituted excessive compensation and disallowed such payments as deductions. Disallowances were also made for portions of the salaries paid in the years 1941, 1942 and 1943, and for 1943 the Commissioner also disallowed as excessive compensation payments of life insurance premiums for taxpayers' benefit.³ The disallowances as to 1945, together with several other minor adjustments, merely resulted in reducing the corporation's net loss for that year from \$45,232.75 to \$21,741.29. (R. 5, 10.) The disallowances as to 1941, 1942 and 1943 re-

¹ The corporation's balance sheets as of December 31, 1944 and 1945, are a part of the stipulated facts. (R. 6.) The 1944 balance sheet shows assets of \$82,911.49 as against liabilities of \$81,592.73 and the 1945 balance sheet shows assets of \$72,201.46 as against liabilities of \$98,709.66.

² The corporation paid no dividends during 1945. (R. 6, 11.)

³ The record does not reveal the date or dates on which any of these determinations and disallowances were made.

sulted in the following deficiencies in tax and interest (R. 5, 10) :

Year	Income tax	Excess profits tax	Interest
1941	\$1,523.64	\$ 1,882.37	\$ 476.14
1942	420.02	20,360.01	3,100.06
1943	221.07	11.63

The application of the net loss carry-back based upon the corporation's adjusted net loss for 1945 resulted in the elimination of the 1942 and 1943 income tax deficiencies and interest thereon and reduced the 1942 excess profits tax deficiency (R. 5, 10-11), leaving unpaid by the corporation the following deficiencies in tax and interest (R. 5, 11) :

Year	Income tax	Excess profits tax	Interest
1941	\$1,523.64	\$1,882.37
1942	6,525.31	\$1,465.33

On December 31, 1947, each taxpayer advanced \$5,250 to the corporation to be used to pay the remaining income and excess profits tax deficiencies and interest. On the same day the corporation paid \$9,931.32 out of those funds to the Collector of Internal Revenue at Buffalo, New York, in partial satisfaction of the deficiencies. On December 24, 1948, each taxpayer paid \$715.37 to the Collector of Internal Revenue at Buffalo in satisfaction of the balance due from the corporation on the deficiencies.⁴ (R. 5-6, 11.) Thus, each taxpayer paid a total of \$5,681.03 on the tax deficiencies of the corporation.

⁴The record contains no explanation for the discrepancy between the total amount of the deficiency taxes and interest (\$11,396.65) and the total amount paid (\$11,362.06).

The Commissioner determined income tax deficiencies for 1945 against each taxpayer, based upon a determination that the life insurance premiums paid by the corporation in that year for their benefit constituted taxable income to them. Taxpayers subsequently filed petitions for review with the Tax Court in which they questioned that determination and also alleged overpayments of their individual 1945 income taxes on the ground that the portions of their 1945 salaries determined by the Commissioner to be excessive as reasonable compensation, and disallowed as deductions to the corporation, did not constitute taxable income to them. (R. 9.) It was later stipulated that the insurance premiums were properly included by the Commissioner in their incomes as additional compensation for 1945. (R. 7.)

The Tax Court held that the 1945 income tax liability of each taxpayer should be recomputed by excluding from the compensation he received and reported in 1945 the amount which he actually paid on the corporation's tax deficiencies in 1947 and 1948 (\$5,681.03 as to each taxpayer).⁵ (R. 11-13.) The Court of Appeals reversed (R. 15-19).

⁵ While taxpayers each advanced the corporation \$5,250 on December 31, 1947, for payment on the corporation's deficiency taxes and each taxpayer on December 24, 1948, paid \$715.37 directly to the Collector on the corporation's deficiency taxes, the amount actually paid by each in satisfaction of the corporation's deficiency taxes was but one-half of the \$9,931.32 which the corporation paid from the total advances of \$10,500, plus the \$715.37 paid by each taxpayer directly to the Commissioner, or a total of \$5,681.03 as to each taxpayer.

SUMMARY OF ARGUMENT

With slight but immaterial variations in the facts, this case involves the same question as *Commissioner v. Hall C. Smith*, now pending before the Court (No. 138, October Term, 1952). These taxpayers received salary in the taxable year 1945 which they reported in their individual income tax returns. Having received the salaries under claim of right and without restriction as to disposition, they are each taxable in 1945 on the full amount of the salaries. Their argument to the contrary, like that of Hall C. Smith, is based upon their alleged transferee liability for the deficiency taxes of their corporation—a liability which was nonexistent until the time subsequent to 1945 when the Commissioner determined that taxpayers' 1945 salaries were in excess of reasonable compensation. The consequential payments by the taxpayers of the corporation's tax deficiencies are immaterial under the "claim of right" doctrine, as we show in our brief in the *Smith* case. For that reason there is also no merit in the taxpayers' additional argument that the corporation's payments of excessive compensation to them constituted void transfers under New York law, for that argument is similarly directed toward establishing, on the basis of determinations made subsequent to 1945, that taxpayers' receipt of their 1945 salaries was attended by a liability to pay over a portion thereof in a later year.

ARGUMENT

The Entire Amount of Salary Received by Each Taxpayer from the Corporation in 1945 is Taxable in that Year Even Though Taxpayers Subsequently Became Subject to Transferee Liability and Paid the Tax Deficiencies of the Corporation

This case, like *Commissioner v. Hall C. Smith*, now pending before the Court (No. 138, October Term, 1952), involves the applicability of the "claim of right" doctrine as related to transferee liability. Unlike the Sixth Circuit in the *Smith* case, the Second Circuit in the instant case regarded the applicability of the "claim of right" doctrine as beyond question and rejected taxpayers' contention that their individual 1945 income tax liabilities should be recomputed by excluding from their 1945 gross incomes the \$5,681.03 each paid in 1947 and 1948 on the corporation's tax deficiencies of prior years. (R. 15-17.) The decision is clearly correct. This case requires consideration apart from the *Hall C. Smith* case only because of a slight variation in basic facts and additional contentions advanced by taxpayers.

A. *It is not open to taxpayers to contend that they did not receive the full amounts of their 1945 salaries in 1945*

Inconsistently, taxpayers disclaim any intention of attempting to raise a new issue or advance a new theory but seek to demonstrate that the decision below is incorrect (Br. 16) through a contention which they now make for the first time (Br. 14-15). The contention evidently arises from the stipulated

fact (R. 5) that *cash* payment of taxpayers' salaries of \$30,000 was made partly in 1945 and partly on March 30, 1946. Taxpayers "concede that it must be assumed" that they each received a note in 1945 covering the balance of their 1945 salaries (\$16,875.90 as to Healy and \$16,821 as to Hartfield, both after deduction of withholding tax of \$5,042.70) and that the notes constituted payment to the extent of their fair market value, but contend that the notes had a combined fair market value of not more than \$7,188.70 as against face value of \$33,696.90.⁶ (Br. 15.) Obviously, this constitutes a contention that they did not receive the full amount of their 1945 salaries in 1945.⁷

Taxpayers have no standing to advance such a contention. In the petitions for review filed by them in the Tax Court (see original record, p. 2 of the petitions), each alleged that "During that year [1945] taxpayer received from the corporation as salary the amount of \$30,000". The answers filed by the Commissioner (Original record, p. 2 of the answers) admitted that "during 1945" each taxpayer "received" from the corporation "salary in the amount of \$30,000". Taxpayers made no request to amend their petitions and at no time until

⁶ Treasury Regulations 111, promulgated under the Internal Revenue Code, Section 29.22(a)-4, provide that—

Notes or other evidences of indebtedness received in payment for services constitute income to the amount of their fair market value. * * *

See also, *Schlémmer v. United States*, 94 F. 2d 77 (C.A. 2d).

⁷ Application of the "claim of right" doctrine in the present case is of course limited to the income received by taxpayer in 1945, the taxable year.

now have they attempted to dispute the above-mentioned allegations in their petitions. The decisions of the Tax Court and Court of Appeals, as well as taxpayers' petition for a writ of certiorari, were all based on the assumption that each taxpayer received the full amount of his 1945 salary in 1945.⁸ It is a well settled rule that allegations in the pleadings are admissions against the party making them and, unless withdrawn or amended, are binding. *Northern Pacific Railroad v. Paine*, 119 U. S. 561; *Scott v. Commissioner*, 117 F. 2d 36, 40 (C.A. 8th); *Sinclair Refining Co. v. Tompkins*, 117 F. 2d 596, 598 (C.A. 5th). Having admitted in their Tax Court petitions that they received the full amount of their 1945 salaries in 1945, taxpayers cannot now be heard to contend the contrary.

If it nevertheless be assumed that the contention

⁸ The Tax Court stated in its findings of fact (R. 10) that—

Each petitioner included in his individual income tax return for 1945 the \$30,000 received as salary. * * *

and as follows in its opinion (R. 11-12):

Petitioners contend that the excessive salaries which they received from the corporation in 1945 are not includible in their incomes because * * *

Respondent contends that the full amount of the salaries received in 1945 is includible in petitioners' incomes * * *. (Italics supplied.)

The summary of facts contained in the opinion of the Court of Appeals includes the following (R. 15):

In 1945 the corporation was insolvent. During that year there was paid by the corporation as salary to each of the above named officers the sum of \$30,000. * * *

In their petition for a writ of certiorari taxpayers quoted the Court of Appeals' summary of the facts, including the above (p. 2); and stated the question presented as being related to compensation "received by the petitioners from an insolvent corporation in 1945" (p. 3).

is open to taxpayers, there is no justification for what seems to be a request by them (Br. 15) that this Court make an original determination on this record as to the fair market value of the notes. That is a factual issue, the original determination of which is for the Tax Court, and, moreover, since the issue was not even raised in the Tax Court, the record contains no evidence specifically directed to it. The only possible recourse, if the contention were open, would be a remand to the Tax Court for hearing and decision on the issue. A remand on a new issue is warranted only in extraordinary circumstances (*Hormel v. Helvering*, 312 U. S. 552, 555-560) and taxpayers do not contend that any unusual circumstance here exists.

This is not a case of hardship or possible injustice to taxpayers, for even the present record reflects that there is no merit in taxpayer's contention that the notes received by them had a total fair market value of no more than \$7,188.70 at the time of receipt in December of 1945. The contention is based on nothing more than an erroneous assumption that the fair market value of the notes was that amount which would have been left for application on the notes if at the end of 1945 the corporation's assets had all been converted into cash and all other liabilities paid. No reason is even given by taxpayers for the assumption that other liabilities as of the end of 1945 were entitled to preference over the notes as of that time. That the fair market value of the notes was equivalent to their face value is reflected by three facts of

record—(1) that taxpayers, who ~~were~~ on the cash receipts and disbursements basis, reported the full amounts of their 1945 salaries in their 1945 income tax returns (R. 10), despite payment of portions of the salaries in notes; (2) that the corporation, which was also on a cash basis (see the corporation's income tax return for 1945, Ex. 3, p. 3, of the original record), claimed deductions in 1945 for payment of the full amounts of the salaries (R. 5, 10); and (3) that the full amounts of the salaries paid in notes (\$16,875.90 as to Healy and \$16,821 as to Hartfield, both after deduction of withholding tax) were actually paid to taxpayers in cash on March 30, 1946 (R. 5), three months after receipt of the notes.

B. Taxpayers' 1945 salaries are taxable in full in 1945 as having been received under claim of right and without restriction as to disposition

The "claim of right" doctrine—under which a taxpayer is taxable in the year of receipt on funds received under a claim of right and without restriction as to disposition—is as equally applicable here as in *Commissioner v. Hall C. Smith*, now pending before this Court (No. 138, October Term, 1952). As we show in our brief in that case, the test of claim of right and without restriction as to disposition is a practical, as distinguished from a legal, test. That this test was met in the present case would seem necessarily to follow, as the court below thought (R. 17), from the fact that the full amount of the 1945 salary of each taxpayer

was reported on taxpayers' individual income tax returns for 1945 as earnings or income. There is, in any event, no evidence to rebut the conclusion that the full amount of the salary of each was received under claim of right and without any practical restriction as to disposition. The court below therefore correctly reversed the Tax Court's holding that taxpayers' 1945 income tax liabilities may be recomputed by excluding from the income of each the amounts he paid in 1947 and 1948 on the deficiency taxes of the corporation.

Taxpayer's contention to the contrary, like the contention of the taxpayer in the *Hall C. Smith* case, rests upon the trust fund doctrine of transferee liability. As we show in our brief in the *Hall C. Smith* case, such a contention simply amounts to an attempt to avoid the application of the "claim of right" doctrine by pointing to the ultimate determination in a later year that the taxpayers' original receipt of salary payments was subject to a liability on the part of the recipients to turn over the amount of the salary (or, as in this case, a portion thereof). The discussion here will be limited to demonstrating that the difference in facts as between the two cases is of no particular importance and to a brief answer of taxpayers' specific arguments.

We do not consider that these taxpayers are in any better position than Mr. Hall Smith merely because they voluntarily paid the deficiency taxes of the corporation without awaiting and contesting

determinations of transferee liability against them.⁹ Transferee liability in both cases necessarily depended upon a determination or determinations made subsequent to the taxable year. In voluntarily accepting transferee liability, taxpayers abandoned their claims of right to portions of their salaries for the taxable year earlier than did Mr. Smith, but that is immaterial so long as the salaries were received under claim of right during the taxable year.

Taxpayers are incorrect in asserting, (Br. 14) that "at the end of 1945" they were under "an existing liability" for federal income taxes of an insolvent corporation. It is transferee liability upon which they rely for their argument that they were liable for taxes of the corporation, and in 1945 there was presumably no reason even to suspect that they were liable as transferees. They could not be held liable as transferees unless they received money or property from the corporation without consideration, and the determination that they had—implicit in the Commissioner's determination that their 1945 salaries were excessive—was not made until subsequent to 1945. It is immaterial that trans-

⁹ We do not contend that taxpayers are in any worse position because they in effect conceded transferee liability. In applying the "claim of right" doctrine, the courts have drawn no distinction between a concession and an adjudication of liability. See *Penn v. Robertson*, 115 F. 2d 167 (C.A. 4th); *Griffin v. Smith*, 101 F. 2d 348 (C.A. 7th), certiorari denied, 308 U. S. 561; *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884 (C.A. 2d), certiorari denied, 330 U. S. 843; and *National City Bank of New York v. Helvering*, 98 F. 2d 93 (C.A. 2d).

ferree liability, when determined, relates back to the time of receipt under the equitable theory of a constructive trust, as we show in our brief in the *Smith* case. It is also immaterial that perhaps only one determination constituting a condition precedent to transferee liability was made in the present case subsequent to the taxable year, whereas in the *Smith* case there were three such necessary determinations. Transferee liability did not exist in the taxable year in the absence of even one determination crucial to transferee liability. It may be noted, however, that the amount of taxes of the corporation actually paid by taxpayers, and for which they are claiming transferee liability, also was not determined until subsequent to 1945.¹⁰ As the court below stated (R. 17):

The liability of the taxpayers as transferees must necessarily have awaited the determination as to the existence and amount of the excessive salary payments. It was not fixed in 1945. Even though corporate insolvency were

¹⁰ Taxpayers' liability as transferees depended not only on a determination that their 1945 salaries were excessive, but upon a determination by the Commissioner that the corporation owed additional taxes for prior years. The record does not reveal whether the latter determination was made prior to the end of 1945. Assuming that it was, still it was not until after 1945 that the amount of taxes of the corporation actually paid by taxpayers was determined. The corporation's deficiencies for prior years were reduced by a carry-back of the corporation's net loss for 1945, the amount of which was not determined until the Commissioner adjusted the corporation's return for 1945, and it was the amount of the corporation's deficiencies for prior years as reduced by the carryback which taxpayers paid in 1947 and 1948 and which they are contending should be deducted from their 1945 incomes.

admitted, the liability of the officers did not exist until excessive payments were determined as a fact, and it was established that a deficiency in the corporate tax existed. * * *

There is no merit in taxpayers' argument that application of the "claim of right" doctrine is precluded because all of the events from which their transferee liability results, including the unreasonableness of their 1945 salaries, relate to and must be determined as of the year 1945 (Br. 8-9), even though "discovery may come in a later year" (Br. 9). It is the fact that discovery came in a later year which permits the conclusion that they received the full amounts of their 1945 salaries under claim of right and without restriction as to disposition. The determination of the existence of conditions precedent to transferee liability subsequent to 1945 on the basis of the facts as of 1945 merely goes to the fact of the ultimate defeat of the taxpayers' right to portions of their 1945 salaries, which, as we show in our brief in the *Hall C. Smith* case, is immaterial. A single illustration may be mentioned here. In *United States v. Lewis*, 340 U.S. 590, the taxpayer was held taxable in the year of receipt on the full amount of salary he received that year, despite a subsequent determination that the salary had been erroneously computed in the taxable year and that, therefore, he was required to return a portion of it.

It does not aid taxpayers to argue (Br. 11) that payment of excessive compensation by an insolvent corporation constitutes a void transfer under Sec-

tion 15 of the Stock Corporation Law of the State of New York (McKinney's Consolidated Laws of New York, Ann., Art. 3, Sec. 15). That argument, like the argument as to transferee liability, rests upon the Commissioner's determination subsequent to 1945 that taxpayers' 1945 salaries were in excess of reasonable compensation. A claim that the receipt of money constituted a void transfer does not preclude application of the "claim of right" doctrine. See *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884 (C.A. 2d), certiorari denied, 330 U. S. 843 (dividends received from wholly owned subsidiary alleged to be void payments as in violation of trust indenture executed by declaring corporation); *Penn v. Robertson*, 115 F. 2d 167 (C.A. 4th) (money received under stock purchase plan allegedly void under state law); *Griffin v. Smith*, 101 F. 2d 348 (C.A. 7th), certiorari denied, 308 U.S. 561 (bonuses allegedly received under unauthorized directors' resolution). In the present case taxpayers have not even shown the existence of conditions precedent to liability under the New York statute. The statute applies only to payments made with the intent of giving preference to creditors (*New York Credit Men's Ass'n v. Hasenberg*, 26 F. Supp. 877 (S.D.N.Y.), affirmed *per curiam*, 107 F. 2d 1020 (C.A. 2d), certiorari denied, 309 U.S. 666) and taxpayers do not even assert that the payments were made with such an intent. Whether liability under the statute could or could not have been established against taxpayers, the fact remains that they received the entire

amount of their 1945 salaries under claim of right and without any practical restriction as to disposition. Cf. *Rutkin v. United States*, 343 U. S. 130.

This case illustrates the incongruity of reliance upon the trust fund doctrine of transferee liability (as well as upon the asserted voidability of the payment of excessive compensation under New York law) as a bar to application of the "claim of right" doctrine. The trust fund doctrine of transferee liability (as well as the New York statute) applies to the entire excessive portion of each taxpayer's 1945 salary, whereas taxpayers are claiming only that part of the excessive portions of their 1945 salaries (the \$5,681.03 each paid on the tax deficiencies of the corporation) should be excluded from their 1945 incomes. This points up the fact that transferee liability, when based on a determination or determinations made subsequent to the taxable year, has significance only as being the reason for abandonment, subsequent to the taxable year, of the claim of right. It does not dissipate the controlling fact—receipt in the taxable year under claim of right and without practical restriction as to disposition.

}

CONCLUSION

The decision below is correct and should be affirmed.

Respectfully submitted,

WALTER J. CUMMINGS, JR.,

Solicitor General.

CHARLES S. LYON,

Assistant Attorney General.

ELLIS N. SLACK,

LEE A. JACKSON,

MELVA M. GRANEY,

Special Assistants to the

Attorney General.

DECEMBER, 1952.

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In the Supreme Court of the United States

OCTOBER TERM, 1952

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

HALL C. SMITH

**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT**

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In the Supreme Court of the United States

OCTOBER TERM, 1952

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, affirming the judgment of the Tax Court.

OPINIONS BELOW

The opinion of the Tax Court (R. 30-35) is reported at 11 T.C. 174. The affirming order of the Court of Appeals (R. 45) is reported at 194 F. 2d 536.

JURISDICTION

The judgment of the Court of Appeals was entered on February 12, 1952. (R. 45.) A petition

for rehearing, filed on March 1, 1952, was denied on April 11, 1952. (R.'46-48.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

In the taxable year 1943, taxpayer received compensation under a claim of right and reported the amount received in his return for that year. In a later year, as a result of litigation, it was adjudicated that the compensation was excessive and that, to the extent of the amount determined to be excessive, taxpayer was liable as a transferee for tax claims against his employer. May taxpayer's 1943 return be reopened to recompute his tax by excluding from his income for that year the amount of compensation subsequently held to be excessive and subject to transferee liability?

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a). [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 42.)

STATEMENT

The facts as stipulated (R. 27-30) were adopted by the Tax Court as its findings (R. 31-33). They may be summarized as follows:

During 1942 and 1943, the taxpayer was the president and sole stockholder of the Charles E. Smith & Sons Company (hereinafter called the Company). For its 1942 and 1943 fiscal years the Company paid to taxpayer for his services a salary of \$52,000 and \$87,265.08, respectively, and deducted these amounts in its income and declared value excess profits tax returns for those years. Thereafter, the Commissioner determined that these amounts exceeded a reasonable allowance for compensation for taxpayer's services to the extent of \$27,000 for 1942 and \$57,265.08 for 1943, and that to the extent of these excessive payments taxpayer was liable as transferee for the Company's tax deficiencies. The Company and the taxpayer each contested the Commissioner's determinations, and filed petitions with the Tax Court, which were consolidated for hearing. In the proceeding brought by the Company, the Tax Court sustained the Commissioner's disallowance of a portion of taxpayer's compensation for both 1942 and 1943. In the proceeding brought by taxpayer, it held that he was liable as a transferee for the unpaid taxes of the Company to the extent of the excessive compensation he received for 1943, since the payment in that year rendered the Company insolvent. The Tax Court's decisions were entered May 28, 1948. (R. 27-29, 31-32.) Both the Company and taxpayer appealed, and the Tax Court's decisions were affirmed by the Court of Appeals for the Sixth Circuit on October 20, 1950. *Charles E. Smith*

& Sons Co. v. Commissioner, 184 F. 2d 1011. Certiorari was denied March 26, 1951. 340 U.S. 953.

Taxpayer reported the full amounts of salary received from the Company in 1942 and 1943 in his income tax returns for those years, and paid the tax shown to be due thereon. He received these amounts under a claim of right, and has ever since retained them. He had no knowledge of the proposed disallowance of a portion of these amounts as a deduction to the Company until September 1944. In January 1947 he filed a claim for refund of part of the tax paid on his 1943 return, on the ground that he was not taxable on such portion of the compensation he had received and reported in that year as might finally be determined to be excessive and subject to transferee liability. The claim for refund was denied by the Commissioner. (R. 29, 32.)

The Tax Court held that taxpayer's tax liability for 1943 should be recomputed by excluding from the compensation he received and reported in that year such portion as might finally be determined to be excessive and subject to transferee liability.¹ (R. 33-35.) The Court of Appeals affirmed on the authority of *Commissioner v. Wilcox*, 327 U.S. 404

¹ The Tax Court's opinion herein was promulgated August 16, 1948 (R. 30), and its decision was entered October 26, 1948 (R. 36), both of which dates antedated the final adjudication in 1951 (184 F. 2d 1011 (C.A. 6th), certiorari denied, 340 U.S. 953) of whether and to what extent taxpayer was liable as transferee.

(R. 45), and denied the Commissioner's petition for rehearing. (R. 46-48).

REASONS FOR GRANTING THE WRIT

1. The decision below is plainly contrary to this Court's rulings in *United States v. Lewis*, 340 U.S. 590, and *North American Oil v. Burnet*, 286 U. S. 417, and is in direct conflict with the decisions in *Commissioner v. Hartfield*, 194 F. 2d 662 (C.A. 2), and *Fleischer v. Commissioner*, 158 F. 2d 42 (C.A. 8). The Court of Appeals for the Second Circuit, in *Commissioner v. Hartfield*, *supra*, rejected a claim indistinguishable from that of the taxpayer in this case with the short observation that "citation of *North American Oil v. Burnet*, *supra*, and *U. S. v. Lewis*, *supra*, would seem to be sufficient to demonstrate that" the attempt to reopen a tax return for a prior year because of subsequently accrued transferee liability must fail. 194 F. 2d at 663.² The judgment of the Tax Court in the pres-

² Similarly in direct conflict with the decision below is the Eighth Circuit's decision in *Fleischer v. Commissioner*, *supra*, relied upon by the Second Circuit in *Hartfield*. In the *Fleischer* case, the taxpayers were corporate officers whose salaries for 1941, which they reported and on which they paid taxes for that year, were ruled to have been excessive and were disallowed in part as a deduction to the corporation in 1943. On the advice of counsel, the taxpayers repaid to the corporation a sum equal to the resulting deficit in the corporation's balance sheet and then sought refunds of their 1941 taxes on the theory that they had received the amounts subsequently repaid "as constructive trustees and subject to an obligation to restore them to the corporation if its capital became impaired." That theory, adopted below in the instant case, was rejected by the Eighth Circuit on the authority of *North American Oil v. Burnet*, *supra*.

ent case, as in *Hartfield*, was rendered prior to this Court's decision in *United States v. Lewis*. In its brief order of affirmance, the court below omitted any reference to the intervening *Lewis* decision by this Court and relied exclusively upon *Commissioner v. Wilcox*, 327 U. S. 404, which was distinguished in *Lewis* (340 U. S. at 591-592) and has since been limited "to its facts" in *Rutkin v. United States*, 343 U. S. 130, 138.

2. The decision below is irreconcilable with the rule of the *Lewis* and *North American Oil* cases that income received under a "claim of right" is taxable to its recipient in the year of receipt or accrual "even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." *United States v. Lewis, supra*, at 591, quoting and reapplying the language of *North American Oil v. Burnet, supra*, at 424. In the *Lewis* case a taxpayer-employee reported in his 1944 income tax return compensation he had received in that year under a claim of right. As a result of subsequent litigation, it was determined that he had had no valid claim to a portion of the compensation because it had been erroneously computed, and in 1946 he refunded the excess to his employer. This Court sustained the Government's contention that the taxpayer could not reopen and recalculate his 1944 tax liability so as to exclude from his income for that year the subsequently repaid portion of his compensation, but should have

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deducted the repayment as a loss in his 1946 return. The Court stated (340 U. S. at 591-592):

In the *North American Oil* case we said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." 286 U. S. at 424. Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. * * *

Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C., §§ 41, 42; and see *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, *Law of Federal Income Taxation*, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.

Here, as in *Lewis*, the taxpayer received compensation under a "claim of right," reported it and paid the income tax on it for the taxable year of receipt, and was required to relinquish part of it in a subsequent year because of litigation resulting in a determination that his compensation had been excessive. It is immaterial that in this case the

taxpayer's subsequent liability to restore part of his compensation was imposed upon him as a "transferee" in equity and accrued to the benefit of his employer's creditor (the Government) rather than directly to the employer. All that matters here, as in *Lewis*, is the fact (stipulated in this case) that the taxpayer received the compensation in the earlier year "under a claim of right and has ever since retained" it (R. 29). Indeed, even if he had knowingly obtained the compensation under a false or invalid claim, he would have been required to report it and pay the tax on it in the year of its receipt. *Rutkin v. United States, supra*.

The decision below proceeds upon the theory that the taxpayer, in the light of the judgment years later that he was liable as a transferee, had received his compensation in 1943 subject to an immediate and unconditional obligation to relinquish a portion of it in satisfaction of the Government's tax claim against his employer (R. 34-35).³ But this theory rests upon a misreading of the undis-

³ The Tax Court also suggested (R. 35) that "injustice" would result unless taxpayer were permitted to reopen his 1943 return so as to exclude the portion of the compensation later found to be excessive and subject to transferee liability. In the *Lewis* case this Court rejected the same argument (340 U. S. at 592 n.):

It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I.R.C., § 322 (b).

puted facts and, as is illustrated by the conflicting decisions in *Commissioner v. Hartfield* and *Fleischer v. Commissioner*, *supra*, departs from the controlling principles settled by this Court. The taxpayer's liability as transferee, nonexistent and presumably unsuspected when he reported and paid the tax on his 1943 income, arose only after it had been finally determined, much later, that (1) his compensation had been excessive, (2) his corporate employer had been rendered insolvent by the payment, and (3) the employer owed additional taxes to the Government. First apprised in September of 1944 that a part of his compensation for 1943 might be held to have been excessive (R. 29), the taxpayer strenuously contested his potential liability in litigation extending into the year 1951. *Charles E. Smith & Sons Co. v. Commissioner*, 1947 P-H T. C. Memorandum Decisions, par. 47,128, affirmed, 184 F. 2d 1011 (C.A. 6), certiorari denied, 340 U. S. 953. These unquestioned facts cannot be reconciled with the notion that the taxpayer received his compensation in 1943 subject to an immediate liability to repay a portion of it. Cf. *Dixie Pine Co. v. Commissioner*, 320 U. S. 516; *Lucas v. American Code Co.*, 280 U. S. 445.⁴

⁴ Disposing of the same issue in *Commissioner v. Hartfield*, *supra*, the Court of Appeals for the Second Circuit said (194 F. 2d at 663):

The liability of the taxpayers as transferees must necessarily have awaited the determination as to the existence and amount of the excessive salary payments. It was not fixed in 1945. Even though corporate in-

In short, it is clear that the taxpayer in this case properly reported and paid income tax on his 1943 compensation. His subsequent liability to relinquish the equivalent of part of that compensation affords no ground for reopening and recalculating his tax for 1943. For the subsequent liability cannot operate here, any more than it did in *United States v. Lewis, supra*, to erase retroactively the dispositive fact that the compensation in question was received "under a claim of right and without restriction as to its disposition * * *." 340 U. S. at 591.

3. Because the error in the decision below seems plain, and because the stipulated facts present no need for further exposition in briefs and argument, the Government respectfully submits that this is an appropriate case for summary reversal on the authority of the *Lewis* and *North American Oil* decisions. We submit, in any event, that the decision below of the recurrent question in this case, conflicting squarely with decisions of the Second and Eighth Circuits,⁵ requires review by this Court.

solvency were admitted, the liability of the officers did not exist until excessive payments were determined as a fact, and it was established that a deficiency in the corporate tax existed.

⁵ It should be noted that, in addition to the direct conflict with the *Hartfield* and *Fleischer* cases, the decision below is incompatible with the premise accepted in *Commissioner v. Arrowsmith*, 193 F. 2d 734 (C.A. 2), and *Commissioner v. Switlik*, 184 F. 2d 299 (C.A. 3). In those cases stockholders who reported capital gains on corporate liquidations were in later

CONCLUSION

The petition for a writ of certiorari should be granted and the decision below reversed on the authority of *United States v. Lewis*, 340 U. S. 590, and *North American Oil v. Burnet*, 286 U. S. 417.

Respectfully submitted,
PHILIP B. PERLMAN,
Solicitor General.

JUNE, 1952.

years adjudged liable as transferees for claims against the corporations. Both decisions assumed that the returns for the years in which the gains were reported could not be reopened to reflect the transferee liability, and the only issue litigated was whether the payments satisfying this liability were to be deducted in the year of payment as capital or ordinary losses. On this issue the two decisions are themselves in conflict, and the taxpayer in *Arrowsmith* has filed a petition for a writ of certiorari, No. 753, this Term.

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No. 138

In the Supreme Court of the United States

OCTOBER TERM, 1952

COMMISSIONER, OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE SIXTH CIRCUIT**

BRIEF FOR THE COMMISSIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1952^{ss}

No. 138

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE COMMISSIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 21-25) is reported at 11 T. C. 174. The affirming order of the Court of Appeals (R. 30) is reported at 194 F. 2d 536.

JURISDICTION

The judgment of the Court of Appeals was entered on February 12, 1952 (R. 30). A petition for rehearing, filed on March 1, 1952, was denied on April 11, 1952 (R. 31-33). The petition for a writ of certiorari was filed June 18, 1952, and granted on October 13, 1952 (R. 34). The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

QUESTION PRESENTED

In 1943 taxpayer received salary from a corporation owned by him and reported it in full in his income tax return for that year. In 1951, however, as a result of litigation, it was finally determined that the compensation was excessive and that, to the extent of the amount determined to be excessive, taxpayer was liable as a transferee for tax claims against the insolvent corporation. May taxpayer's 1943 tax be recomputed so as to exclude from his income for that year the amount of compensation subsequently held to be excessive and subject to transferee liability?

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U. S. C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 42.)

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection.*—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same

manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter * * *:

(1) *Transferees*.—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

* * * * *

(26 U. S. C. 1946 ed., Sec. 311.)

STATEMENT

The facts as stipulated (R. 19-21) were adopted by the Tax Court as its findings (R. 22). They may be summarized as follows:

During the fiscal years ending July 31, 1942, and July 31, 1943, taxpayer was the president and sole stockholder of the Charles E. Smith & Sons Company. For these two fiscal years the company paid to taxpayer for his services a salary of \$52,000 and \$87,265.08, respectively, and deducted these amounts in its income and declared value excess profits tax returns for those years (R. 19-20, 22).

Taxpayer reported these amounts in full in his income tax returns for the calendar years 1942 and 1943, and paid the tax shown to be due thereon. It is expressly stipulated that he received these amounts (R. 20)—

under a claim of right and has ever since retained said amount of salaries, and had no knowledge of the proposed disallowance

of said salaries as a deduction to said company until September of 1944.

Subsequent to the filing of the 1942 and 1943 returns, the Commissioner determined tax deficiencies against the company for 1942 and 1943, based in part upon the disallowance as deductions of \$27,000 of the salary paid to taxpayer in 1942 and of \$57,265.08 of the salary paid to him in 1943, the Commissioner having determined that to the extent of those amounts the salary paid to taxpayer exceeded a reasonable allowance for compensation for his services to the company.¹ The Commissioner also determined that to the extent of the excessive salary, \$27,000 for 1942 and \$57,265.08 for 1943, taxpayer was liable as transferee for the company's tax deficiencies. The company and taxpayer each contested the Commissioner's determinations and filed petitions with the Tax Court, which were consolidated for hearing. In the proceeding brought by the company, the Tax Court sustained the Commissioner's action in disallowing the above-stated portions of taxpayer's 1942 and 1943 salary as deductions. In the proceeding brought by taxpayer, the Tax Court held that taxpayer was liable as transferee for the unpaid taxes of the company to the extent of the excessive compensation he received

¹The record in *Charles E. Smith & Sons Co. v. Commissioner*, No. 545, 1950 Term (R. 9, 21) shows that "90-day" letters, advising the company and Smith that the Commissioner had determined deficiencies in tax liability, were dated September 13, 1945.

in 1943 (\$57,265.08), since the payment of that amount to taxpayer rendered the company insolvent in 1943. (R. 20, 22; *Charles E. Smith & Sons Co. v. Commissioner*, decided May 12, 1947, 1947 P-H T. C. Memorandum Decisions, par. 47,128.)² Both the company and taxpayer appealed, and the Tax Court's decisions were affirmed by the Court of Appeals for the Sixth Circuit on October 20, 1950. *Charles E. Smith & Sons Co. v. Commissioner*, 184 F. 2d 1011. Certiorari was denied on March 26, 1951. 340 U. S. 953.

In the meantime, in January 1947, taxpayer filed a claim for refund of part of the tax paid on his 1943 return, on the ground that he was not taxable on such portion of the compensation he had received and reported in that year as might finally be determined to be excessive and subject to transferee liability. The claim for refund was denied by the Commissioner (R. 21). The Commissioner subsequently determined a deficiency against taxpayer for 1943 income tax based upon the disallowance of a deduction for payment of certain real estate taxes (R. 21). Taxpayer thereafter filed a petition for review with the Tax Court in which he alleged that, instead of a deficiency being due, he had overpaid his taxes and was entitled to a refund of the taxes he had paid on his excessive salary for 1942 and 1943 (R. 21).

² The pertinent portions of the Tax Court's opinion are set out in the Appendix, *infra*, pp. 31-38.

The Tax Court held that taxpayer's 1943 tax liability should be recomputed by excluding from his 1943 reported income the excessive portion of his 1943 salary (\$57,265.08) which under the Tax Court's decision in *Charles E. Smith & Sons Co. v. Commissioner, supra*, represented the extent of taxpayer's liability as a transferee for the unpaid 1942 and 1943 deficiency taxes and penalties of the company³ (R. 21-25). The Court of Appeals affirmed (R. 30) and denied the Commissioner's petition for rehearing (R. 33).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In failing to hold that taxpayer received his 1943 salary, including the portion subsequently determined to be in excess of reasonable compensation, under a claim of right and without restriction as to its use and that, accordingly, the entire amount of the salary was taxable in 1943.

2. In concluding that taxpayer's receipt of the portion of his 1943 salary subsequently held to have been in excess of reasonable compensation constituted "the bare receipt of property or

³ The Tax Court's opinion was promulgated August 16, 1948 (R. 21), and its decision was entered October 26, 1948 (R. 25), both of which antedated the final determination in 1951 (*Charles E. Smith & Sons Co. v. Commissioner*, 184 F. 2d 1011 (C. A. 6th), certiorari denied, 340 U. S. 953) of whether and to what extent taxpayer was liable as transferee. However, the final determination was affirmance of the Tax Court's decision.

money wholly belonging to another" and in holding, on the basis of that conclusion, that taxpayer's 1943 income tax liability should be recomputed by excluding the excessive compensation from his 1943 gross income.

SUMMARY OF ARGUMENT

The "claim of right" doctrine, applied by this Court in *North American Oil v. Burnet*, 286 U. S. 417, and *United States v. Lewis*, 340 U. S. 590, and recently reiterated in *Arrowsmith v. Commissioner*, decided November 10, 1952 (No. 51, October Term 1952), requires that income tax be paid in the year of receipt on money received under a claim of right and without restriction as to its disposition, even though it may in a later year be determined that the taxpayer was not entitled to retain the money and that he is legally required to return it or pay it over to someone else. In the present case it is stipulated that taxpayer received his entire 1943 salary under such a claim of right. He thus properly reported the entire salary as income in that year. Determinations made subsequent to 1943—that his 1943 salary exceeded reasonable compensation, to the extent of \$57,265.08, that payment of the excess rendered his corporate employer insolvent, that the corporation was liable for additional taxes to the Government, and that taxpayer is accordingly liable as transferee for the unpaid deficiency taxes of the corporation to the extent of the \$57,265.08

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constituting the excessive portion of his 1943 salary—establish his right to take a deduction in the year in which he satisfies such transferee liability, but do not entitle him to amend his 1943 return in order to reduce his taxable income for that year.

The decision below, holding that taxpayer's 1943 income tax may be recomputed by excluding the \$57,265.08 from his 1943 gross income, is a fundamental departure from the "claim of right" doctrine. Presumably because taxpayer's transferee liability is based on the equitable theory that, as of the time of receipt, the excessive compensation constituted a constructive "trust fund" for payment of the transferor's deficiency taxes, the court below concluded that taxpayer's receipt of the excessive compensation constituted the receipt of money wholly belonging to another. But this "trust fund" existed only as a legal fiction, and it came into being only when it was determined, in a year later than 1943, that taxpayer was not legally entitled to retain such salary. That the chancellor could, for purposes of equitable relief, regard such a fund as if it had always been held in "trust," from the very moment it was received by the taxpayer, does not alter the realities of the transaction upon which tax liability and accounting must depend. Taxpayer did not receive the salary subject to an actual or express trust; as a practical matter, there was no restriction upon his disposi-

tion or use of it (cf. *Rutkin v. United States*, 343 U. S. 130, 137). It is expressly stipulated that at no time before 1944 did taxpayer have any knowledge that the company's deduction for such salary might be disallowed. The decision below is therefore based upon facts, determined subsequent to 1943, which defeated the taxpayer's claim of right to the excessive compensation at the time of receipt. But it is the existence of a claim of a right, and not a subsequent determination as to its ultimate validity, which is decisive.

Reversal of the decision below is required by the *North American Oil* and *Lewis* decisions of this Court, as well as by the rationale of *Rutkin v. United States*, *supra*.

ARGUMENT

The entire salary received by taxpayer in 1943 is taxable in that year, even though he was subsequently held liable as a transferee, under a theory of constructive trust, for the company's tax deficiencies to the extent of a portion of his salary.

On appeal to the court below, the Commissioner argued that the entire salary received by taxpayer in 1943 is taxable to him in that year under the "claim of right" doctrine, which the Court of Appeals for the Second Circuit found no difficulty in applying to similar facts in *Commissioner v. Hartfield*, 194 F. 2d 662, now pending before this Court *sub nom. Healy and Hartfield v. Commissioner*, No. 76, October Term, 1952. The court below, however, held in effect that, because of tax-

payer's subsequently determined transferee liability for the unpaid 1942 and 1943 deficiency taxes of the company to the extent of the subsequently determined excessive part of his 1943 salary, his 1943 income tax liability should be recomputed by excluding from his gross income the excessive portion (\$57,265.08) of the total salary (\$87,265.08) he received and reported in 1943. The reason for the holding given in the brief affirming order of the court (R. 30) was—

that the receipt of the excessive salary to the extent of which the respondent was held liable as transferee constituted "the bare receipt of property or money wholly belonging to another," *Commissioner v. Wilcox*, 327 U. S. 404, and that the respondent held the funds not for himself but for the creditors of the transferor * * *

This conclusion cannot be reconciled with the controlling principles laid down in decisions of this Court.

A. The "claim of right" doctrine

The "claim of right" doctrine, "now deeply rooted in the federal tax system" (*United States v. Lewis*, 340 U. S. 590, 592), was stated in *North American Oil v. Burnet*, 286 U. S. 417, 424, as follows:

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not en-

titled to retain the money, and even though he may still be adjudged liable to restore its equivalent. * * *

In *United States v. Lewis*, *supra*, this Court refused to depart from that "well-settled" "interpretation of the tax laws" (p. 592). In *Arrow-smith v. Commissioner*, decided November 10, 1952 (No. 51, October Term, 1952), where decision was based on the assumption that the "claim of right" doctrine applied despite subsequently determined transferee liability, the Court again referred to the "well-established principle that each taxable year is a separate unit for tax accounting purposes." (Slip opinion, p. 3.)

As the Court stated in *Lewis* (p. 592), the "claim of right" doctrine "has long been used to give finality" to the annual accounting period for which income taxes must be paid on income received. Payment of tax on the basis of an annual accounting period (see *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363, 365-366; *Heiner v. Mellon*, 304 U. S. 271, 276-277) requires a determination of income at the close of each taxable year "without regard to the effect of subsequent events" (*Haberkorn v. United States*, 173 F. 2d 587, 589 (C. A. 6th); *Penn v. Robertson*, 115 F. 2d 167, 175 (C. A. 4th)). Under the "claim of right" doctrine, therefore, taxes are laid in the year of receipt upon funds received under a claim of right and without restriction as to their use, regardless of subsequent claims or

adjudications as to the recipient's right to retain the funds.

It is necessarily implicit in the "claim of right" doctrine that taxpayer-recipient's claim of right at the time of receipt may subsequently be defeated. Indeed this is clear in the opinion in the *North American Oil* case itself. There the Government had instituted suit to oust the taxpayer from possession of a section of oil land, a receiver was appointed to operate the property and hold the net income thereof, and in 1917, after entry by the district court of a final decree dismissing the Government's suit, the 1916 profits from the operation of the oil lands were paid to the taxpayer. Those profits were held taxable to the taxpayer in 1917, the year of receipt, even though the litigation on which the taxpayer's right to the profits depended continued in process and was not terminated until 1922. As the Court there stated (p. 424)—

If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. Compare *Lucas v. American Code Co.* [280 U. S. 445].

For a similar case, see *Commissioner v. Alamitos Land Co.*, 112 F. 2d 648 (C. A. 9th), certiorari denied, 311 U. S. 679. The more usual type of case is where the validity of the taxpayer's claim

to the funds at the time of receipt is questioned subsequent to the year of receipt, as in *United States v. Lewis*, 340 U. S. 590. There the "claim of right" doctrine was applied to that portion of the taxpayer's compensation which it was later determined had been erroneously computed and which, accordingly, he was under a legal obligation to return.⁴ For similar situations—that is, where the doctrine was applied despite a later determination defeating the taxpayer's claim to the income at the time of receipt—see, e. g., *Haberkorn v. United States*, 173 F. 2d 587 (C. A. 6th) (involving a situation similar to the *Lewis* case); *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884 (C. A. 2d), certiorari denied, 330 U. S. 843 (dividends received from wholly owned

⁴ While cases of the type where the validity of the taxpayer's right to the funds at the time of receipt has been questioned are the most pertinent here, application of the "claim of right" doctrine is not of course limited to such cases. See, e. g., *Gilken Corp. v. Commissioner*, 176 F. 2d 141, 144-145 (C. A. 6th); *Capital Warehouse Co. v. Commissioner*, 171 F. 2d 395 (C. A. 8th); *Anderson v. Bowers*, 170 F. 2d 676 (C. A. 4th), certiorari denied, 337 U. S. 918; *De Guire v. Higgins*, 159 F. 2d 921 (C. A. 2d); *Clay Sewer Pipe Ass'n v. Commissioner*, 139 F. 2d 130 (C. A. 3d); *Jacobs v. Hoey*, 136 F. 2d 954 (C. A. 2d), certiorari denied, 320 U. S. 790; *Caldwell v. Commissioner*, 135 F. 2d 488 (C. A. 5th); *Detroit Consolidated Theatres v. Commissioner*, 133 F. 2d 200 (C. A. 6th); *Boston Consol. Gas Co. v. Commissioner*, 128 F. 2d 473 (C. A. 1st); *First Nat. Bank v. Commissioner*, 107 F. 2d 141 (C. A. 6th); *Commissioner v. Lyon*, 97 F. 2d 70, 73-74 (C. A. 9th).

subsidiary alleged to be void payments as in violation of trust indenture executed by declaring corporation); *Penn v. Robertson*, 115 F. 2d 167 (C. A. 4th) (money received under stock purchase plan allegedly void under state law); *Saunders v. Commissioner*, 101 F. 2d 407 (C. A. 10th) (officer's commission on sale of stock allegedly improperly received); *Griffin v. Smith*, 101 F. 2d 348 (C. A. 7th), certiorari denied, 308 U. S. 561. (bonuses allegedly received under unauthorized directors' resolution); *National City Bank of New York v. Helvering*, 98 F. 2d 93 (C. A. 2d) (illicit bonus).

In all these cases it was determined, in a year after the money was received, that there was in a legal restriction upon the taxpayer's disposition of the money, dating back to the time of receipt. Yet that was held immaterial—the crucial inquiry being, was it *received* under a claim of right without a *practical* restriction upon its disposition? Or, as it was put in *Rutkin v. United States*, 343 U. S. 130, 137, did taxpayer, as a practical matter, derive “readily realizable economic value from it” upon receipt? If the taxpayer holds under a claim of right in the year of receipt, he is taxable “regardless of any ~~in~~firmity of his title” (*National City Bank of New York v. Helvering*, *supra*, p. 96) and even though he may be “mistaken” as to the validity of his

claim” (*United States v. Lewis, supra*, p. 591).

In *Commissioner v. Wilcox*, 327 U. S. 404, relied upon by the court below (R. 30), it was held that embezzled funds were not income to the embezzler because the receipt of the embezzled funds constituted the “bare receipt of property or money wholly belonging to another” (p. 408). As the Court noted in *Lewis* (p. 591), however, the *Wilcox* case did not impair the “claim of right” doctrine. In *Wilcox* the Court found that the taxpayer-embezzler “received the money without any semblance of a bona fide claim of right” (p. 408) and in *Lewis* (pp. 591–592) the Court reiterated that in *Wilcox* it distinguished the *North American Oil* “claim of right” doctrine—

on the ground that an embezzler asserts no “bona fide legal or equitable claim.”
327 U. S. at 408.

In the present case, as we shall show, there was clearly far more than a “bare receipt of property or money wholly belonging to another” (*Wilcox*, p. 408). This taxpayer received his salary, as the stipulated facts (R. 20) disclose, believing it was his to do with as he liked and without any thought that he might someday be required to surrender part of it.

B. Application of the “claim of right” doctrine to these facts

In the present case taxpayer received in 1943 and reported in his income tax return for that year his total salary of \$87,265.08. It was sub-

sequently held that the salary was excessive as compensation to the extent of \$57,265.08 and that to that extent taxpayer is liable as transferee for the unpaid 1942 and 1943 deficiency taxes of the company, the 1943 payment to him having rendered the company insolvent. This transferee liability is the basis for the holding below that taxpayer's 1943 income tax liability may be recomputed by excluding \$57,265.08 from his 1943 gross income.

The Commissioner's determination of transferee liability against taxpayer was made under the authority of Section 311(a) of the Internal Revenue Code (*supra*, pp. 3-4), which imposes no new liability but provides a summary procedure for enforcing transferee liability at law or in equity (*Phillips v. Commissioner*, 283 U. S. 589; *Phillips-Jones Corp. v. Parmley*, 302 U. S. 233; *Harrison v. Commissioner*, 173 F. 2d 736 (C. A. 5th); *Pearlman v. Commissioner*, 153 F. 2d 560 (C. A. 3d)—a procedure which is the same as that provided for collection of taxes directly from a taxpayer (see *Phillips v. Commissioner*, *supra*). The taxpayer's transferee liability in equity is based on the principle that a corporation should not be permitted to transfer its assets without consideration and leave remediless those having unsatisfied claims against the corporation. *Pierce v. United States*, 255 U. S. 398, 402-403. Thus, it has long been settled that a distribution of

assets of a corporation without consideration, made when the corporation is insolvent or which leaves the corporation insolvent, will, when those facts are established, be deemed to be impressed with a trust as of the time of receipt for payment of the corporation's debts. *Curran v. State of Arkansas*, 15 How. 304, 307-308; *Pierce v. United States*, *supra*; *Phillips v. Commissioner*, *supra*, p. 605; *Harrison v. Commissioner*, *supra*; *Scott v. Commissioner*, 117 F. 2d 36 (C. A. 8th); *McWilliams v. Excelsior Coal Co.*, 298 Fed. 884, 886 (C. A. 8th).

This "trust fund doctrine" (*Phillips-Jones Corp. v. Pgrmley*, *supra*, p. 235) is based on the theory of a constructive trust—a trust which arises where a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it (Restatement of the Law, Restitution, Sec. 160, p. 640; 3 Scott on Trusts, Sec. 462, p. 2315). The constructive trust "is a remedial and not a substantive institution." Scott on Trusts, *supra*, p. 2316. As stated in 3 Bogert, Trusts and Trustees, Part 1, Sec. 471, it is "the device used by chancery" to compel one who unfairly holds a property interest to convey that interest to another to whom it justly belongs (pp. 3-4), "merely a tool of the court to work out an equitable result in the simplest fashion" (p. 5), "the formula

through which the conscience of equity finds expression" (p. 6). A court of equity constructs the trust, and makes the defendant a trustee "by virtue of the decree of the court" (Bogert, *supra*, p. 5), in order to vindicate the principle that the defendant has been under an equitable duty to give the complainant the benefit of the property ever since he began to hold unjustly (Bogert, *supra*, pp. 4-5).

In short, therefore, the liability of a constructive trustee arises only as the result of a determination or adjudication thereof, subsequent to the transactions or events upon which the liability is founded. It arises, not out of the desire or agreement of the parties, but rather out of the court's remedial powers.

While Section 311(a) of the Code (*supra*, pp. 3-4) dispenses with the requirement of an independent action in law or equity to impose and enforce transferee liability, no transferee liability exists or is enforceable under Section 311(a) in the absence of an assessment of transferee liability against an alleged transferee. *Hulburt v. Commissioner*, 296 U.S. 300, 305-306. Indeed, the Commissioner may assert transferee liability against any one transferee (*Phillips v. Commissioner*, *supra*, pp. 603-604) and no transferee is under an obligation to relinquish money or property received from a corporation until transferee liability is asserted against him or

until a fellow transferee seeks contribution from him.⁵

In the present case taxpayer's transferee liability resulted from an assessment against him based upon a determination of the Commissioner, affirmed by the Tax Court and the Court of Appeals, that \$57,265.08 of his 1943 salary was in excess of reasonable compensation (and consequently a distribution of money of the corporation without consideration) and that the payment thereof rendered the payor-corporation insolvent. Cf. *Commissioner v. Renyx*, 66 F. 2d 260 (C. A. 2d); *West v. Commissioner*, 68 F. 2d 246 (C. A. 3d); *Lovejoy v. Commissioner*, decided June 15, 1942 (1942 P-H T. C. Memorandum Decisions, par. 42,344); *Estate of Murphy v. Commissioner*, decided August 26, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49,205). As conditions precedent to the imposition of transferee liability for unpaid deficiency taxes of the corporation, it had to be determined, in the first instance by the Commissioner, (1) that taxpayer's 1943 salary was excessive, (2) that the payment of the excessive portion rendered the corporation insolvent, and (3) that the corporation was liable for additional taxes to the Government. None of these

⁵ When once determined or established, transferee liability extends to the entire amount received by the transferee without consideration. *Phillips v. Commissioner*, *supra*, pp. 603-604.

determinations was made until after the close of the taxable year 1943. Transferee liability resulted only from application of the legal fiction of constructive trusts. The application of such a fiction presents an altogether different situation from receipt of money as trustee under an express or implied-in-fact trust, where the receipt is of money or property wholly belonging to another and precludes an assertion of claim or right thereto by the trustee as an individual. The constructive trustee is not even treated as a real trustee.

As stated in Scott on Trusts, *supra*, p. 2316:

It is not infrequently said that where a person would be unjustly enriched if he were permitted to retain property, a court of equity "converts him into a trustee." The expression is misleading. The defendant is not converted into a real trustee. He is not even treated as though he were a real trustee, except that he is not permitted to retain the property for his own benefit. One would hardly say that where a quasi-contractual obligation is imposed the court converts the defendant into a contractor, or converts the obligation into a contract.

The "trust" relationship involved in the determination of transferee liability here, although retroactive in theory, did not arise until 1951 when the Commissioner's determinations were finally sustained. To be sure, this meant that taxpayers' claim of right in 1943, although it

existed in fact, was without basis in law. But this is of course immaterial. The possibility that a claim of right might subsequently be defeated is of the essence of the doctrine, the very function of which is to provide a practical and workable basis for the computation and payment of taxes on an annual basis, notwithstanding that possibility. What the court below apparently overlooked is that the test of receipt of funds "under a claim of right and without restriction as to its disposition" (*North American Oil v. Burnet*, *supra*; p. 424; *United States v. Lewis*, *supra*, R. 592) is necessarily a *practical* and not a legal test. Cf. *Rutkin v. United States*, 343 U. S. 130, 137.

It is certainly clear that, from a practical standpoint, taxpayer received the excessive portion of his 1943 compensation under a claim of right and without restriction as to its disposition. He received his entire 1943 salary as salary and reported it as earnings or income in the year of receipt. It is a stipulated fact that the entire salary was received "under a claim of right." (R. 20.) That it was received without any practical restrictions as to its disposition is confirmed by the stipulated fact (R. 20) that he "had no knowledge of the proposed disallowance of said salaries as a deduction to said company until September of 1944."

Taxpayer does not deny that his liability for unpaid taxes of the corporation was, as a practi-

cal matter, nonexistent and unsuspected when he reported and paid tax on his 1943 income. First apprised in September 1944 that a part of his compensation for 1943 might be held to have been excessive (R. 20), he strenuously contested his potential transferee liability in litigation extending into the year 1951. *Charles E. Smith & Sons Co. v. Commissioner*, decided May 12, 1947 (1947 P-H T. C. Memorandum Decisions, par. 47,128), affirmed, 184 F. 2d 1011 (C. A. 6th), certiorari denied, 340 U. S. 953. His liability as transferee arose only after the Commissioner's determinations had finally been sustained in that litigation.

In disagreement with the court below, other courts of appeals have applied the "claim of right" doctrine, notwithstanding that the money involved constituted a constructive trust fund retroactive to the time of receipt. Like the present case, *Fleischer v. Commissioner*, 158 F. 2d 42 (C. A. 8th), involved the applicability of the doctrine despite transferee liability resulting from the receipt of excessive compensation. The taxpayers there contended that the excessive amounts were received as constructive trustees and subject to an obligation to restore them to the corporation if its capital became impaired. The Eighth Circuit nevertheless sustained the Tax Court's holding in that case that the excessive amounts were taxable under the "claim of right" doctrine. In *St.*

Regis Paper Co. v. Higgins, 157 F. 2d 884 (C. A. 2d), certiorari denied, 330 U. S. 843, where a corporation received dividends from a wholly owned subsidiary which were alleged to be void payments as in violation of a trust indenture executed by the declaring corporation, it was stated (p. 885): ..

But even though it now be conceded that the appellant could have been charged as a constructive trustee, (the claim of right under which it did receive the dividends and hold them as its own until some time in 1938 is enough to make them income to the trustee for tax purposes in the year of their receipt.

In *National City Bank of New York v. Helvering*, 98 F. 2d 93 (C. A. 2d), which involved an illicit bonus consisting of bonds, it was contended, *inter alia*, that the decedent-taxpayer was not taxable on the bonds because he held them as constructive trustee. To that the Second Circuit replied in part (p. 95):

They [the bonds] were of course the property of the Prairie company in the sense that it could have reclaimed them:
* * *. But there are several cases in which persons have been taxed upon property which could be recovered from them.

In *Commissioner v. Alamitos Land Co.*, 112 F. 2d 648 (C. A. 9th), certiorari denied, 311 U. S. 679, it was contended that a fund collected by a judg-

ment creditor was a trust fund until disposition of the appeal. The Ninth Circuit held the taxpayer taxable on the fund, stating that it was on the reversal of the judgment that the trust relationship arose and that the reversal of the judgment was a newly created right.

In essentially the same circumstances as are involved in the present case, both the Second and Eighth Circuits have thus upheld application of the "claim of right" doctrine. *Commissioner v. Hartfield*, 194 F. 2d 662 (C. A. 2d), now pending before this Court *sub nom. Healy and Hartfield v. Commissioner*, No. 76, October Term, 1952; *Fleischer v. Commissioner*, 158 F. 2d 42 (C. A. 8th). Similarly, the Tax Court has applied the doctrine in holding that a stockholder's gain on the liquidation of a corporation may not be recomputed by deducting the amount of taxes which, as transferee, the stockholder paid in a subsequent year.* *Pittman v. Commissioner*, 14 T. C. 449; cf. *Furlong v. Commissioner*, 45 B. T. A. 362. Indeed, the applicability of the doctrine despite transferee liability for unpaid taxes has seemed so clear that it was accepted without question in cases in which stockholders who reported capital gains on corporate liquidations were in later years adjudged liable as transferees for claims against the corporations.

* That holding would require a similar holding in the present case and in the *Healy and Hartfield* case, *supra*, but in both cases the Tax Court failed to apply the "claim of right" doctrine.

Commissioner v. Arrowsmith, decided by this Court November 10, 1952 (No. 51, October Term, 1952); *Commissioner v. Switlik*, 184 F. 2d 299 (C. A. 3d). Both of those decisions assumed that the returns for the years in which the gains were reported could not be reopened to reflect the transferee liability and the only issue litigated was whether the payments satisfying this liability were to be deducted in the year of payment as capital or ordinary losses. In *Arrowsmith* this Court, in holding that losses were deductible as capital losses in the later years, looked to the transaction events in the earlier year in order properly to classify the nature of the loss for tax purposes, but expressly noted that—

Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.⁷

The decision below is thus plainly at odds with the "claim of right" doctrine. The decision, being based on taxpayer's subsequently determined transferee liability under the constructive trust fund theory, would exclude from taxation any money or property received under circumstances in which a court of equity might thereafter impress a constructive trust. Since a court of equity will impress a constructive trust

⁷ Slip opinion, p. 3.

upon any fund inequitably held by a taxpayer, the decision below would necessarily exclude from taxation *any* money or property as to which it was subsequently found the taxpayer had no valid claim as of the time of receipt, as in *Lewis* itself. Regardless of the reason why the receipt was illegal, whether because it was obtained by extortion, as in the *Rutkin* case, or because it rendered the corporation insolvent, as in this case, the characterization of the recipient as a "constructive trustee" would suffice to exclude tax liability. But, of course, if that were so, then *Lewis*, *Rutkin* and the other cases above cited were erroneously decided.

The instant case is, indeed, *a fortiori* from *Rutkin*, since the taxpayer there obviously knew at the time of receipt that he had no valid claim to the money. It may be noted that the court below has itself, in *Haberkorn v. United States*, 173 F.2d 587, demonstrated why *Commissioner v. Wilcox*, 327 U. S. 404, upon which it here relies, does not preclude application of the "claim of right" doctrine in the present case. In the *Haberkorn* case the court below had before it a case similar to *Lewis*; that is, a case in which, after the taxpayer had received and reported compensation in 1942, it was found in 1944 that the compensation had been erroneously computed and that he was not entitled to a portion of it. The court there held that the entire amount received in 1942 was tax-

able in that year. *Wilcox* was correctly distinguished on the ground (173 F. 2d at 590) that, since in the *Haberkorn* case the overpayment was not discovered until a subsequent year—

the debtor-creditor relationship, although definite and unconditional in 1944, was not recognized or even claimed in 1942.

* * * The title to the money so received passed at that time from the employer to the employee. Subsequent developments in a later year gave rise to the obligation to repay it. * * * In the present case, at the end of 1942 Haberkorn had possession, title and unrestricted use of the money, and was claiming it and treating it as his own. There was not even any pending or ascertained claim against it. * * *

whereas in *Wilcox*—

The receipt of the money by the embezzler and the obligation to return it occurred simultaneously.

The same is true here. As of the time of receipt this taxpayer, unlike the taxpayer in *Wilcox*, received the money involved under a bona fide claim of right.

The Tax Court suggested (R. 25), and taxpayer will undoubtedly argue, that “injustice” will result unless taxpayer is permitted to reopen his 1943 return so as to exclude the portion of compensation later found to be excessive and subject to transferee liability. In the *Lewis* case this

Court rejected a similar argument, stating (340 U. S. at 592 fn.):

It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I. R. C. § 322 (b).

Taxpayer's relief for payment of the transferee liability is to claim a loss deduction in the year of payment. *North American Oil v. Burnet*, *supra*. Income is not to be taken out of the annual accounting system to produce a supposedly more equitable result to either the taxpayer or the Government.⁸ *Security Mills Co. v. Commissioner*, 321 U. S. 281, 285-286. Incongruously, this taxpayer is seeking to reopen his 1943 return to enable him to take a deduction in that year for a payment which he admits he has not even yet made (see R. 20).

No injustice or inequity results simply because the Commissioner is claiming the excessive compensation on behalf of the United States for un-

⁸ Taking the loss deduction in the year of payment, instead of reopening the earlier return, will in some instances work to the disadvantage of a taxpayer and in other instances to the taxpayer's advantage, depending upon the circumstances, particularly the rates of tax for the two years and the tax bracket in which the amount of the taxpayer's income places him.

paid deficiency taxes of the corporation while at the same time seeking to impose tax upon taxpayer's receipt of the money. In *North American Oil* the taxpayer was held taxable on income which the United States was claiming for itself even at the time of receipt by the taxpayer. It should make no difference to the instant taxpayer, or to the application of the "claim of right" doctrine, which of the corporation's creditors has claimed the excessive portion of his 1943 compensation.

CONCLUSION.

The judgment of the Court of Appeals should be reversed.

Respectfully submitted,

ROBERT L. STERN,
Acting Solicitor General.

CHARLES S. LYON,
Assistant Attorney General.

PHILIP ELMAN,
ELLIS N. SLACK,
LEE A. JACKSON,
MELVA M. GRANEY,
*Special Assistants to the
Attorney General.*

NOVEMBER 1952.

APPENDIX

The following are the pertinent portions of the Tax Court's opinion in *Charles E. Smith & Sons Co. v. Commissioner*, decided May 12, 1947 (as amended October 28, 1947) (1947 P-H T. C. Memorandum Decisions, par. 47,128):

OPINION

The first question presented for our determination in these proceedings is—what is a reasonable allowance for compensation for services actually rendered by Smith to the corporation during the fiscal years ending July 31, 1942 and July 31, 1943?

The corporation in its income tax returns for the taxable years deducted \$52,000 for the fiscal year ending July 31, 1942 and \$87,265.98 for the fiscal year ending July 31, 1943, as compensation paid to Smith for services rendered by him during those years. The respondent determined that a reasonable allowance for compensation for Smith for the services he rendered was \$25,000 for the taxable year 1942 and \$30,000 for the taxable year 1943.

This Court has repeatedly pointed out that the burden of proving the reasonableness of salaries paid by a corporation is upon the petitioner. In other words, the petitioner must show that the amounts allowed by the respondent were unreasonably small, since the respondent's determination is presumptively correct.

In the instant proceedings we have the rather familiar situation of a corporation

all of whose stock was owned by one individual, Smith, who was also its president and general manager. In the years preceding those here involved, the corporation paid him a salary which generally ranged from \$4,800 to \$7,500, but which amounted to \$10,800 in 1937. Its business of manufacturing shirts and operating a small men's furnishings' store had not been very successful, and in 1940 it was forced into bankruptcy. As of July 31, 1941, its balance sheet showed assets of only \$3,745.97, composed of cash, notes, accounts receivable, inventory, and furniture and fixtures, as against current liabilities of \$9,850.02, and a deficit of \$36,104.05. Shortly after the beginning of its next fiscal year, the corporation was the successful bidder on a contract for some tow targets for the Army Air Corps. On October 1, 1941, Smith, whose salary had been \$4,800 in the preceding fiscal year, decided that it should be increased to \$52,000 per annum, and at a stockholders' meeting on that date a resolution was adopted that his salary should be increased to this amount. Smith was the only stockholder present; and he knew at that time that the corporation was the low bidder on the Air Corps contract, bids for which had been opened on September 15th. When asked why he fixed his salary at \$52,000, he testified that that was what he hoped his services would be worth; that the size of the Air Corps contract had something to do with it; and that he considered the amount of time "it seemed as though I would have to spend on the job." His salary of \$87,265.08 for the fiscal year ending July 31, 1943, was likewise authorized by a resolution adopted by him as sole stockholder, and was computed on the basis

of 15 per cent of the corporation's net sales for the fiscal year.

Petitioners attempted to prove that \$52,000 and \$87,265.08 constituted a reasonable allowance for salary for Smith by describing in detail the services he rendered. Thus, it was shown that Smith prepared the bids that resulted in the contracts, arranged for the purchase of sewing machines and other necessary equipment for the purchase of a building sufficiently large to handle the work, hired the personnel, arranged for any financing necessary over and above the advance payments on the contracts made by the government, suggested changes in specifications and blueprints to facilitate mass production, assisted in the repair and servicing of machines, made and recommended new target designs, and spent long hours in the performance of these duties. No evidence was submitted by petitioners, however, indicating that any similar business paid comparable amounts to an officer or officers for services such as were performed by Smith, and cases cited in petitioners' brief as to salaries allowed by this Court as reasonable compensation are of little help inasmuch as the facts presented in those proceedings are not comparable to those here involved.

We are not impressed by petitioners' attempt to prove that Smith performed some unique and highly technical services. With certain minor exceptions, the targets were manufactured in accordance with specifications and blueprints furnished by the government, which also furnished most of the cloth used in their manufacture. The principal part of the manufacturing process consisted of cutting the cloth, sew-

ing it together on about forty sewing machines operated by girls, and attaching flotation tubes. The inspector in charge of procurement, inspection for the Army Air Corps in the Cincinnati District during the taxable year testified, as a witness for the respondent, that the manufacture of the two targets was a comparatively simple process, and we have reached the same conclusion after a careful consideration of all the evidence. Our best judgment is that a reasonable allowance for compensation for services rendered by Smith was \$25,000 for the fiscal year ending July 31, 1942, and \$30,000 for the fiscal year ending July 31, 1943, and we have made such a finding.

* * * * *

The decision of the first two issues in favor of the respondent establishes the liability of the transferor corporation for the deficiencies and penalty determined by the respondent. There remains for consideration the liability of Smith, as transferee. The burden of proving this liability is on the respondent. Petitioners contend that he has not sustained this burden because he has not established that the corporation was made insolvent by the payment it made to Smith either during the taxable year ending July 31, 1942, or July 31, 1943. They also urge that credit or offset should be allowed, in determining transferee liability for whatever income taxes Smith may have paid by reason of having included in his individual income tax returns the full amounts paid to him during the taxable years.

Respondent contends that petitioner Charles E. Smith and Sons Company became insolvent during the fiscal year end-

ing July 31, 1942, and that therefore Hall C. Smith is liable as transferee for the deficiencies and penalty of the transferor corporation for that taxable year. While, as is hereinafter more fully set forth, we do find that Hall C. Smith has a transferee liability for said deficiencies and penalty for the taxable year ending July 31, 1942, we are unable to base such finding upon respondent's contention that Charles E. Smith and Sons Company was insolvent prior to July 31, 1942. Its balance sheet as of July 31, 1942, is in evidence and is set forth in our findings. It discloses that the book value of its assets as of that date exceeded the amount of its liabilities, exclusive of capital stock, by approximately \$25,000. There is no evidence that the actual value of the assets at that time was less than the book value. The deficiencies and penalty determined by the respondent against the corporation for the fiscal year ending July 31, 1942, totalled \$7,980.95. Even taking into consideration this potential liability for Federal taxes, the corporation was not insolvent at the close of the fiscal year. We cannot hold, therefore, that the distributions to Smith during that year rendered the corporation insolvent, and made him liable as transferee. [As amended by order dated 10-28-47.]

The events, however, which transpired during the fiscal year ending July 31, 1943, lead us to a different conclusion. As shown in the preceding paragraph, the corporation was solvent at the beginning of that year. The respondent on brief urges that the \$30,000 distributed to petitioner on January 7, 1943, in redemption of 300 shares of stock should be considered as

one of the distributions which rendered the corporation insolvent and thus created transferee liability. However, no such allegation was made by him in his answer and this item, not being put in issued by the pleadings, cannot be considered by us. The allegation in the answer is limited to the distributions of \$92,856.08, made to petitioner for salary and pension. On September 3, 1942, the board of directors adopted a resolution that Smith's salary for the fiscal year ending July 31, 1943, be 15 per cent of its net sales. This amounted to \$87,265.08, \$57,265.08, of which we have held to be in excess of reasonable compensation for Smith's services for that year. The amount of \$5,591 contributed to the pension fund during the year for the benefit of Smith did not constitute a distribution of corporate profits to him. Cf. *Lincoln Electric Co.*, 6 T. C. 37, 51. Our question is whether as a result of the distribution to Smith of \$57,265.08 the corporation became insolvent during the fiscal year ending July 31, 1943. If it did, Smith is liable as transferee. If it did not, he is not liable. [As amended by order dated 10-28-47.]

The balance sheet of the corporation as of July 31, 1943, shown in our findings, shows an excess of assets over liabilities in the amount of \$65,084.32. The petitioners contend that, based upon adjusted valuations, the corporation was solvent at the end of the year and could pay any tax owing by it or even the proposed deficiencies determined by the respondent. They urge that the realty was carried at the book value of \$75,008.54 against the mortgage obligation of \$66,000, leaving an equity of approximately \$9,000; that the realty was worth at

least the amount of \$102,000 received for it at the sheriff's sale in 1945; that at this valuation the equity amounted to approximately \$40,000 (\$102,000 less \$66,000); and that the net worth of the corporation at the end of the fiscal year would amount to \$105,000 (\$65,084.32 plus \$40,000), or more than enough to take care of its tax liability for the fiscal year ending July 31, 1943.

Certain adjustments in the corporation's balance sheet as of July 31, 1943, are necessary in order to determine whether the distribution of \$57,265.08 made to Smith resulted in the insolvency of the corporation. The item "Treasury Stock—\$30,000.00", representing the 300 shares acquired from Smith on January 7, 1943, should be eliminated as an asset, and capital stock liability should be reduced from \$60,000 to \$30,000. The balance sheet does not reflect the actual value of the realty. It was purchased in April, 1942, at a cost of \$85,463.85, and sold at a sheriff's sale in 1945 for \$102,000. No evidence was submitted as to its actual value as of July 31, 1943. This was the respondent's burden and in order that petitioners may not be prejudiced by his failure to sustain it, we are making the adjustment to \$102,000, as they suggest, although we realize that this figure represents the realty's value in 1945, rather than in 1943, and that its value in 1942 was \$85,463.85. The balance sheet carries as the corporation's liability for income and excess profits tax, the amount of \$22,427.70. This figure should be adjusted to \$118,890.87, which represents the deficiencies and penalty in the aggregate amount of \$7,980.95 for the fiscal year ending July 31, 1942, and the corporation's liability for income, declared value excess-

profits, and excess-profits taxes aggregating \$10,909.92 for the fiscal year ending July 31, 1943. "In determining the question of insolvency, a liability for taxes, though unknown at the time, must be considered." *Scott v. Commissioner*, 117 F. 2d 36 [26 AFTR 245]. When these adjustments are made, the balance sheet discloses assets of \$173,525.24, and liabilities of \$207,912.63, exclusive of capital stock, and that the corporation was insolvent. This condition resulted from the aforementioned distribution of \$57,265.06 made to Smith, and to the extent of this distribution he is liable as transferee for the deficiencies in tax and penalty, determined by the respondent for the fiscal years ending July 31, 1942 and July 31, 1943. *Scott v. Commissioner, supra*. [As amended by order dated 10-28-47.]

* * * * *

No. 138

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In the
Supreme Court of the United States

October Term, 1952

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COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

HALL C. SMITH,
Respondent.

BRIEF OF RESPONDENT, HALL C. SMITH

SOL GOODMAN,
1016 Union Trust Building,
Cincinnati, Ohio,
Attorney for Respondent.

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In the
SUPREME COURT OF THE UNITED STATES

October Term, 1952

No. 138

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

HALL C. SMITH,

Respondent.

BRIEF OF RESPONDENT, HALL C. SMITH

STATEMENT OF FACTS

The taxpayer was president and sole owner of the capital stock of the Charles E. Smith & Sons, Co., a corporation under the laws of Ohio. As president, he was paid a salary for the year 1943 of \$87,265.00. The salary was determined to be excessive for income tax purposes to the extent of \$57,265.08. As a result of said determination the excessive portion was not allowed as a deduction to the corporation thus resulting in an increase in the corporation's income tax and excess profit tax. The amount of the assessment exceeded all the assets of the corporation at the end of its 1943 fiscal year by some \$34,000.00; and by reason of loss sustained by the corporation in the year 1944, the tax

assessments now exceed the corporation's assets by about \$80,000.00. The Commissioner asserted a transferee tax liability against the taxpayer for the portion of the salary which was determined to be excessive, and upon which he had theretofore paid income tax.

In the year in question the corporation withheld part of taxpayer's salary to apply on his income tax and remitted the same to the Collector. The taxpayer filed Estimated Tax Returns and prepaid tax on a portion of his salary. At the end of the taxable year he filed tax returns and paid the balance of the taxes.

The claim for refund attached to the petition set forth that during the year 1943 taxpayer paid through Withholding, Declaration of Estimated tax, and with tax return, a total of \$59,488.25. If only the salary that he should have received, that is \$30,000.00 for the year 1943, was included in his Tax Return, the total income tax due thereon would have been \$12,624.25. The taxpayer therefore contends that he overpaid the amount of \$46,864.00.

The undisputed facts disclose that in the year 1943 out of \$87,000.00 which he was supposed to receive as his salary he had the economic use of only \$28,000.00 and the balance of \$59,000.00 went directly to the government in the form of withholding taxes which never reached him, Declaration of Estimated Taxes which he prepaid during the year, and the balance of the taxes paid within several months of the end of the year. While he (R. 29, paragraph 7) received a salary of \$87,000.00 under claim of right and has reported said amount of salary, however (Paragraph 6, R. 29), *he made payments through Withholding, Declaration of Estimated Tax, and at time of filing of return of \$59,000. Thus the amount that he ever received or held under claim of right and had the economic use of, is only \$28,000.*

Those are the admitted facts and it is in line with those facts that the court must consider the present case.

ARGUMENT

Where an individual receives compensation from a corporation, amounting to \$87,000.00 per annum, and by withholding pre-payment and income taxes pays thereon \$59,000.00, and retains \$28,000.00 for his own use; and where the Government asserts a liability as transferee against said individual, for an amount of \$57,000.00 of the \$87,000.00 by reason of the fact that only \$30,00.00 is held to be reasonable salary, and that the excess of \$57,000.00 was impressed with a trust in favor of the Government. Quaere: May the individual receive a refund of the tax paid on the income impressed with a trust in favor of the government and which he must return to the Government, or a credit on the transferee liability?

Answer: The Tax Court held "yes". The Court of Appeals held "yes".

The taxpayer contends that the answer should be "yes". We direct the Court's attention to *The Law of Federal Income Taxation, Mertens, Vol. 2, page 594, Section 17.08*:

"Where the taxpayer receives payment which cannot be legally devoted to his own uses but under the terms of a trust, express or implied, must be devoted to the benefit of some other person or to some particular purpose not relating to the interest of the taxpayer, it is necessarily held that the taxpayer does not receive income of a character which should be taxed to him personally. It is the beneficial owner who is subject to the tax. The restrictions on the use of the receipts, of course, must be proved."

If the taxpayer was not entitled to the salary, then, of course, he owed no income tax thereon. The government retaining the amount of tax which the individual paid must give due credit to the individual in a transferee liability for such amount. *U. S. v. Klausner*, 25 Fed. 2nd 609.

5. "Where transaction, which former owners of corporate stock claimed was sale of corporate assets of \$100,000 and sale of defendant's stock of \$100,000 was sale of corporate assets for \$200,000 defendants, being liable after dissolution of corporation, for additional taxes assessed against corporation because of profit on sale of assets, were entitled to credit for over-payment they may have made on personal income taxes by reason of reporting \$50,000 each as income from sale of his stock."

Also, in the case of *U. S. v. Brown*, 86 Fed. 2nd, 798:

"Under doctrine of election, United States could not maintain bill in equity against stockholders to whom corporation's assets were distributed on dissolution, to recover unpaid income taxes which had been assessed against corporation, on ground that stockholders held assets charged with trust in favor of United States, where Commissioner had pressed to its conclusion, assessment against stockholders for their share of sum received on liquidation, less cost to their stock, on ground that entire amount of liquidating dividend constituted income to stockholders."

The Tax Court, in its opinion, which appears in the record at pages 30 to 35, clearly distinguished the cases which are argued and cited by the Commissioner in this Court. We direct this Court's attention to the opinion of the Tax Court where it stated (R. 34), 11 T. C. 174:

"... The determination of this Court that the petitioner is liable in equity, as transferee, can mean only that he received the transferor's assets (the excessive compensation) impressed with a trust in favor of the Government's claim against the transferor for unpaid taxes. The petitioner held the funds not for himself but for the creditors of the transferor.

"Since *Eisner v. Macomber*, 252 U. S. 187, the 'use and benefit' theory has been accepted as a guiding principle in determining income tax liability. It has become almost axiomatic in our tax law that individual tax liability results only from the receipt of income, in money or the equivalent, for the taxpayer's beneficial use.

"In *Commissioner v. Wilcox*, 327 U. S. 404, the Supreme Court said that 'a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) *the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain.*' The Court further said that 'the bare receipt of property or money wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of Section 22 (a).'"

Also (R. 35):

"The instant case is distinguishable from cases like *North American Oil Consolidated v. Burnet*, 286 U. S. 417, dealing with the receipt of income 'under a claim of right and without restriction as to its disposition.' Here, there was a definite legal restriction of the petitioner's use of the excessive compensation which attached the moment that he received it. Such is the nature of a transferee liability.

"There is obvious inconsistency, as well as injustice, in the respondent's position in seeking to tax the petitioner on income to which he, the re-

spondent, has successfully laid claim on the ground that it was never the petitioner's income by right."

This case does not compare with the same Court's decision in *Haberkorn v. U. S.*, 173 F. 2d 587, but is more like the decision in the case of *Knight Newspapers, Inc. v. C. I. R.* 143 F. 2d, p. 1007. The distinction made in those two cases by the Court is upon the same basis as the rule so often repeated by this Court, and set forth in the case of *U. S. v. Lewis*, 340 U. S. 590. In those cases, the Courts have held that where a taxpayer received earnings under a claim of right *and without restriction as to its disposition it is subject to tax*. One cannot, on one hand, assert that when the money was received by the taxpayer, *he held it as a trustee*, and was subject to transferee liability, and on the other hand argue that *he received it without restriction as to its disposition and thus subject it to tax*.

Having in mind particularly that as a practical matter, the taxpayer had no economic use of the money, the money having been withheld from him by the employer under the withholding tax provision, he having paid the money to the Government under the pre-payment tax plan, and he being liable under the Statute as a trustee to account to the Government for the money which he received impressed with a lien; can the Commissioner, under such circumstances, honestly assert a claim that the taxpayer *received the money without restriction?*

As was stated by the Tax Court, (R. 35):

"There is obvious inconsistency, as well as injustice, in the respondent's position in seeking to tax the petitioner on income to which he, the respondent, has successfully laid claim on the ground that it was never the petitioner's income by right."

The Court of Appeals, after giving due consideration to the briefs and oral argument, rendered its decision, which is as follows:

Commissioner of Internal Revenue v. Hall C. Smith,
194 F. 2d 536:

"This case came on to be heard on the record and briefs and oral argument of counsel.

"And it appearing that the Tax Court of the United States, in a prior proceeding, held the respondent liable in equity as a transferee for unpaid taxes of a corporation, and that the decision of the Tax Court, 11 T. C. 174, was affirmed by this court in *Charles E. Smith & Sons Co. v. Commissioner*, 6 Cir., 184 F. 2d 1011, certiorari denied 340 U. S. 953, 954, 71 S. Ct. 572, 95 L. Ed. 687.

"And it appearing that the receipt of the excessive salary to the extent of which the respondent was held liable as transferee constituted 'the bare receipt of property or money wholly belonging to another', *Commissioner of Internal Revenue v. Wilcox*, 327 U. S. 404, S. Ct. 546, 90 L. Ed., 752, and that the respondent held the funds not for himself but for the creditors of the transferor;

"It is ordered that the decision of the Tax Court be, and it hereby is, affirmed."

Thereafter the Petitioner filed a Petition for rehearing and directed the Court of Appeals' attention to the decision by the Second Circuit in the case of *Commissioner v. Hartfield*, 194 F. 2d, 662. The attention of the Court was again directed to the decision by this Court in the case of *U. S. v. Lewis*, 340 U. S., 590, and *Rutkin v. U. S.*, 343 U. S. 130.

The same Court of Appeals had theretofore decided the case of *Haberkorn v. U. S.* 173 F. 2d, 587, and was fully aware that its position and decision in that case had been

approved by this Court in *U. S. v. Lewis*. It recognized the differences and distinctions between the rule pronounced in those cases, from the rule which should be applied to, the facts in the present case, and over-ruled the Petition for Rehearing.

The case of *Fleischer v. Commissioner*, 158 F. 2d 42 is cited by Petitioner as being in conflict with the decision in the present case. A mere reading of the facts in that case indicates that there is no conflict. There is no insolvent corporation with a transferee liability involved in that case. There, there had been a payment of excessive salaries, which the officers refunded to the corporation. Somewhat similar is the factual situation in the case of *Commissioner v. Hartfield*, 194 F. 2d, 662. There the officers refunded excessive salaries either to the corporation, or applied it on the payment of the additional tax imposed on the corporation. In the present case as is pointed out in the brief of Commissioner, the transferee liability remains unpaid, as well as the tax obligation of the taxpayer involved herein, both items are still open by reason of this litigation. An adjustment of that year's liabilities is still to be made. *Is it not fair, just, and proper that there be a refund issued to this taxpayer, or in the adjustment of differences, that he be given a credit, and have it applied on the transferee liability?*

In this connection, we direct the Court's attention to what was said by the same Court of Appeals in the case of *U. S. v. Cummins Distilleries Corporation*, 166, F. 2d. 17, at page 23:

"In *Bull v. United States*, 295 U. S. 247, 55 S. Ct. 695, 79 L. Ed. 1421, and *Stone v. White*, 301 U.S. 532, 57 S. Ct. 851, 81 L. Ed. 1265, the Supreme Court found no difficulty in preventing injustice, either to the government or to the tax-

payer, and in avoiding unjust enrichment of either, upon equitable conceptions of justice, and by the application of a historic remedy comparable to equitable recoupment (301 U. S. 539, 57 S. Ct. 854). It concluded that where money is taken through mistake its unjust retention is immoral and amounts in law to a fraud on the taxpayer's rights (295 U. S. 247, 55 S. Ct. 695), and even though the sovereign is not liable to respond to a petition of the taxpayer, the right it has given him to credit it or refund is available to him when the government proceeds against him for the collection of a tax. In *Rothensies v. Electric Battery Co.*, 329 U. S. 296, 67 S. Ct. 271, 273, the Supreme Court wisely undertook to confine this principle so as to limit recoupment to those defenses which arise out of the transaction upon which the government's claim is based. The principle itself was not rejected. It was sought, however, more clearly than was generally supposed, to limit it in the revival of stale claims to those deriving from the same transaction, so as to preserve the salutary effect of statutes of repose, for it would be intolerable to have an income tax system under which there never would come a day of final settlement. 'A statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.'

"The decision in the *Rothensies* case has, however, no application to the present situation. There is here no effort to revive stale claims as a set-off against a live tax liability. The Distilleries Corporation admits that it owes 1941 and 1942 taxes in stipulated amount. The government inter alia sued for their collection. It now has the money and if the decision of the District Court and our own affirmance of it are sound it has neither legal nor moral right to keep it, unless that right arises out of the antecedent debt. That

right the appellees concede, and need not by us be questioned. Nothing in the *Rothensies* case, as we view it, precludes adjudication that the government apply the collection to the valid tax debt. So viewing the problem, it becomes unnecessary to explore the purpose of the Collector in crediting the enforced collection, in conflict with conventional practice, upon a disputed rather than upon a conceded tax liability, upon a later rather than upon an earlier debt, nor to consider whether such credit, which after all is but a book-keeping entry grounded in mistake, is irrevocable."

In the case of *Floyd v. Scofield*, 193 F. 2d, 594, the Court stated that the dominant purpose of revenue laws is taxation of income to those who earn or otherwise create right to receive it and enjoy the benefit of it when paid. When money is received under a claim of right, but impressed with a lien so that the government can follow it, and claim it from the taxpayer, and claim it from someone to whom he has transferred it, can it be said that he has the absolute right to use it. In the case last mentioned, the Court has said that the power to dispose of income is the equivalent of ownership of it. In the present case, the taxpayer had no right to dispose of the income because it was impressed with a lien in favor of the government.

In the case of *Harrison v. Commissioner*, 173 F. 2d, 736 the Court stated that a transferee of private property, burdened with debts of the transferor, receives the property as trustee, charged with such debts, and is required to disgorge so much of the property as is necessary to discharge the indebtedness. This Court has repeatedly held that the transferee liability, either at law or at equity, was one that was essential for the proper administration of the tax laws.

The Commissioner, if he were successful in sustaining his stand in the present case, would lose a considerable amount of potential tax money. If taxpayers receive money at the time when they become liable as transferee, but the money is not ear-marked for the government, and the lien impressed thereon is not such which in effect, places title in the government, then in such cases, there would be no justification for the Commissioner's pursuing the transferee and the transferee's transferee.

The position of the Commissioner is not only shortsighted, but is highly unfair and unjust. At page 11 of the Petition, he asks this Court to reverse the decision which was given due consideration by the Tax Court of the United States, and by the Court of Appeals, where all the judges in the two lower courts concurred, this Court is asked to not even give it consideration and hearing, but to reverse it on the basis that the error in the decision below seems plain. The same arguments advanced in this Court in this Petition and Brief, was advanced in both of the lower courts, and to those courts it did appear plain the other way, that is that the Commissioner is wrong.

We believe that this Court will not agree with the Solicitor General, but will rather feel that the right stand is set forth and taken by the Circuit Court in the case of *Stockstrom v. Commissioner*, 190 F. 2d, at 289, when it said:

"It has been well said that the government should always be a gentleman. Taxpayers expect, and are entitled to receive, ordinary fair play from tax officials."

We respectfully submit that upon due consideration, this Court will find that the decision of the Tax Court, and the decision of the Court of Appeals affirming it, were in all respects correct. The Tax Court, and the affirmance of

its decision by the Court of Appeals, have been more than fair to the Commissioner in their decisions. The taxpayer had actually paid \$46,000.00 in taxes, on the \$57,000.00 excessive salary, which was impressed with a lien and trust in favor of the government. It is only by reason of the operation of the Current Tax Payment Act of 1943 that the taxpayer can only recover the amount of the refund, or credit amounting to \$33,000.00. This decision was rendered with the full eye towards fairness in favor of the government; and the decision should be that the Petition for Certiorari is denied.

SOL GOODMAN,
1016 Union Trust Bldg.,
Cincinnati 2, Ohio,
Attorney for Respondent.

July 31, 1952.

PETITION

FOR

REHEAR-

ING

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No. 138

In the
United States Supreme Court

October Term, 1952

COMMISSIONER OF INTERNAL REVENUE

Petitioner,

vs.

HALL C. SMITH,

Respondent.

PETITION FOR REHEARING

SOL GOODMAN,

1016 Union Trust Building,

Cincinnati, Ohio.

Attorney for Respondent.

In the
UNITED STATES SUPREME COURT

October Term, 1952

No. 138

COMMISSIONER OF INTERNAL REVENUE

Petitioner,

vs.

HALL C. SMITH,

Respondent.

PETITION FOR REHEARING

The Court rendered its opinion and decision on April 6, 1952. Within 15 days thereof, the respondent, Hall C. Smith files this petition for rehearing pursuant to the provisions of Rule 33 of this Court; Counsel signing the Petition for Rehearing, certifies that this is not being filed for the purpose of delay, but is presented in good faith and founded upon the sincere belief of counsel that the Court has been led astray by the contentions and arguments in the Brief of Petitioner which actually are not in issue in this case.

Petitioner's entire argument, sustained by the Court's opinion, is based upon the well established rule that income tax accounting is to be upon an annual basis and that any adjustments occurring in subsequent year transactions should not be reflected in prior year tax adjustments. The instant case does not present this question.

Section 272 of the Internal Revenue Code, Title 26, provides that when an assessment is made by the Com-

missioner the taxpayer may file a petition within ninety days with the Tax Court of the United States. The Tax Court of the United States is given jurisdiction to *redetermine the tax liability of the taxpayer for that particular year*. 272 (G) of the Internal Revenue Code limits the jurisdiction of the Tax Court to the particular year and merely permits the Tax Court to look into prior years, but in so doing "shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid."

Pursuant to this provision of the Internal Revenue Code, the petitioner, having made an assessment against respondent (transcript of record, page 7 and page 16) informed the taxpayer as follows:

"If a petition to the Tax Court of the United States is filed against the deficiency proposed herein, the issue set forth in your claim for refund should be made a part of the petition, to be considered by the tax court in any redetermination of your tax liability."

The jurisdiction of the Tax Court to consider and redetermine the liability of the respondent for the year 1943 was not questioned by either the Commissioner or the taxpayer.

The Tax Court was confronted with the situation where the respondent had received \$87,000 as salary during the year 1943 and through withholding and prepayment tax, he paid some \$60,000 thereon in income taxes. *The \$60,000 was received and held by the Commissioner, and in effect, never was in the possession of the taxpayer, so that he could have economic use or benefit thereof.* Thereafter, in a proceeding held in the Tax Court, which is contained in the record in this Court (in Case No. 545 October term.

1950,) the respondent was held liable as transferee for \$57,000 of the \$87,000 salary. The Commissioner asserted a transferee liability against the respondent for the \$57,000 and as a net result, the respondent would have been faced with paying \$117,000 as income tax and transferee liability on \$87,000 of salary. This meant that the Commissioner was seeking to recover from respondent in income tax and transferee liability approximately 140% of the amount he received. *This is in no way a tax on income when it requires you to pay \$1.40 on every \$1.00.*

Having in mind that the Tax Court was redetermining the tax liability of the Petitioner for the year 1943, and that it had therefore held the Petitioner liable as transferee for \$57,000 of the \$87,000, the Court found (transcript of record, page 24):

"Tax Court's determination in the transferee proceeding is not attacked in this proceeding. The Petitioner's only contention here, is that since it has been determined by this Court that he is liable in equity as a transferee for the unpaid taxes of the full amount of excessive compensation distributed to him in the taxable year, such excessive salary may not be included in his taxable income."

ARGUMENT

This Court, in its desire to sustain the sanctity of the rule of "annual accounting," is by its decision in this case, causing a grave injustice. Ever since the decision by Chief Justice Marshall in the case of *U. S. v. Nourse*, 34 U. S. 8, this Court has time and again repeated that no decision of the Court should be permitted to cause an injustice. In the case of *Bull v. U. S.*, 295 U. S. 247, this Court would not permit the United States to hold a collection of income tax and estate tax on the same funds and stated:

"In a proceeding for the collection of estate tax, the United States through a palpable mistake, took more than it was entitled to. Retention of the money was against morality and conscience."

The Court in its opinion permitted a recovery even though the Statute of Limitation had run against the taxpayer. Has "morality and conscience" so far advanced that the government may now take \$117,000.00 in income and transferee tax on \$87,000 of income?

In the case of *Commissioner v. Gooch Milling and Elevator Company*, this Court had under consideration, the provisions of Section 272 of the Internal Revenue Code, and at page 420, this Court found that the Tax Court had jurisdiction to make a redetermination of the amount of the deficiency or overpayment for the particular tax year, as to which the Commissioner determines a deficiency, and as to which the taxpayer seeks a review of the deficiency assessment.

In the case of *Fischer v. Commissioner*, 149 Fed. 2d, 540, Justice Minton, while a member of the Circuit Court of Appeals 7th Circuit wrote the opinion indicating that 26 U.S.C.A. Internal Revenue Code Section 272 gives the Tax Court jurisdiction to redetermine the amount of tax which had been assessed against a taxpayer for a particular year.

In the case of *Rutkin v. United States*, Justice Black, Reed, Frankfurter and Douglas dissented from the opinion and decision of this Court, whereby under the "claim of right" doctrine, income tax was imposed on Rutkin for money which he obtained by extortion.

In the case of *Arrowsmith v. Commissioner*, 344 U.S. 6, 97 L. ed. 19. Justice Douglas, Jackson and Frankfurter dissented from the decision of the Court where-

by this Court apparently did violence to the annual accounting period doctrine by looking back into an earlier year, so as to charge a taxpayer with income tax rates rather than capital gains rates on a deduction. In the case of *Commissioner v. Wilcox*, 327 U. S. 404, this Court held that a thief is not subject to income tax on the money he steals. The Court based its findings on the doctrine that the "claim of right" theory is not applicable because of the restrictions that exists on the gains which the thief has:

It seems a rather harsh definition and conception of justice to say that the thief who steals money may keep it without payment of tax because his claim of right is restricted; but the Court would hold in this case, that a man is subject to tax on money which the Government says *he should not have had*, and successfully took it away from him!

Has the Dobson Rule (*Dobson v. Commissioner* 320, U.S. 489) been so discredited that no weight or consideration is to be given to the judgment of the Tax Court that had the opportunity of seeing the witnesses, hearing their testimony and considering questions of tax law which are normally handled by them from day to day. Does the spirit of the *Dobson Rule* in no way commend the respect of this Court for the judgment in this case made by the United States Court of Appeals for the Sixth Circuit; that considered the decision in the *Healy* case of the United States Court of Appeals of the Second Circuit and distinguished the two?

The respondent in this case feels that great injustice is being done to him by reason of the coupling of his case with the *Healy* case. The facts in the *Healy* case are such that they do not require the Court to make a close scrutiny as to whether these various rules and principles should or

should not be applied. *The application of any rule to a case which results in the Government taking \$1.40 for \$1.00 income shows on its face that such rules do not apply.*

This case presents a situation where an individual worked during a war year for a salary fixed by his corporation at \$87,000. He worked with such great and extreme effort, that at the end, he became a physical wreck and has not been able to work ever since. The imposition of a tax liability and transferee liability of a total of \$117,000.00 on a salary fixed at \$87,000.00 results in a financial calamity to this individual. Not only has he lost his health, but has lost every bit of property as a result of this decision. (Record in Case 545, October, 1950)

During the oral argument of this case, the Court asked the counsel for Petitioner whether or not its stand being taken in this case was one that it applied uniformly. The answer was in the affirmative, but nothing was presented to indicate that such is a fact. A search of the authorities and any information that is available to taxpayers fails to disclose that there ever has been such a policy on the part of the Commissioner. The opinion of this Court seems to imply the existence of such a practice and refers to G. C. M. 16730 XV-1 Cum. Bull. 179 (1936). An examination of the reference indicates that is merely an opinion based on the "claim of right" doctrine, and in no way indicates that the Government's position is such that in cases like the present one they had followed a uniform policy.

As a matter of fact, all indications are that such a policy has not been followed. Congressional enactment of Section 272, giving the Tax Court jurisdiction to make a redetermination; the quotation made at the beginning of our Brief from the Revenue Agent's letter advising the taxpayer to set up his claim in the Tax Court, clearly indicates that

the Government's position has been that the Tax Court is to make a redetermination of all factors known at that time when it considers the ultimate tax liability of a taxpayer for the year in question.

When this matter was presented by oral argument last December, more than a majority of the members of the Court were made aware of the fact that the "annual accounting period" and the "Claim of Right Doctrine" had no application to this case. We pointed out in oral argument that *this was an action opened by the Commissioner and not by the taxpayer. The year 1943 was opened when the Commissioner made an additional assessment and advised the taxpayer to seek a redetermination in Tax Court, not only of the proposed assessment, but also of his claim for refund based upon the transferee liability.* The Tax Court and the Court of Appeals sustained the taxpayer's claim on the theory that the year was opened and could be readjusted and that by reason of their prior judgment, that the Commissioner was bound, and that the taxpayer should not be treated as a transferee liable in one case, and as a recipient of income in another.

Four months elapsed between the oral argument and the rendering of a decision by the Court. The decision clearly indicates that the Court lost sight of the contentions advanced by respondent that he did not seek to open a closed year, but merely followed the direction of the Commissioner and sought a redetermination in line with the holding of the Tax Court and the Court of Appeals that \$57,000.00 of what he thought was salary was actually money belonging to the Government.

If Congress sought to legislate, whereby an income tax of 140% was imposed, this Court would strike it down as being contrary to the 16th Amendment of the Federal

Constitution. The decision of this Court accomplishes just that end.

President Eisenhower appears to be duly alarmed by the existing duplication in taxes brought about by the various Federal and State Governments imposing tax on the same subject. To end such duplication, he has appointed a commission to investigate it. How more grave is the holding and decision of this Court which permits duplication to an extent where 140% is taken under the guise of an income tax law.

We respectfully submit that the decision of this Court does violence to every principle of justice. In order to safeguard an established rule of procedure involving the "annual accounting period," the Court applies that rule to this case in violation of the express enactment of Congress as contained in Section 272 of the Internal Revenue Code, which gives the Tax Court jurisdiction to redetermine a year. *This Court cannot in the face of this record, justify the finding that the year was sought to be reopened by the taxpayer.* The record shows that the Commissioner reopened the year at a time after the transferee liability had been imposed upon the taxpayer at the Commissioner's instance. Under such circumstances, justice demands that the decision of this Court be vacated and a rehearing granted.

Respectfully submitted,

Sol Goodman

1016 Union Trust Building,

Cincinnati 2, Ohio

Attorney for Respondent.

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